A New Understanding of Tax
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Edward J. McCaffery

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*Edward J. McCaffery**

TABLE OF CONTENTS

I. INTRODUCTION 809
A. *Loomings* 809
B. *The Road Ahead* 818
II. IN THEORY: THREE FORMS OF TAX 819
A. *An Example* 819
B. *The Income Tax* 821
C. *Two Forms of Consumption Tax* 824
D. *Two Conditions of Equivalence* 825
1. *Constant Tax Rates* 825
2. *Constant Rates of Return* 826
E. *The Treatment of Debt* 827
III. A PROBLEM OF UNDERSTANDING 829
A. *Means and Ends* 829
B. *The Traditional Logic of Tax* 832
C. *The Modern Income-Versus-Consumption Debate* 838
1. *The Case for Consumption* 838
2. *The Income Empire Strikes Back* 841
3. *Why It Matters* 843

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D. *Two Political Takes* 845
E. *Three Neutralities* 848
1. *Why Even Care About Neutrality?* 848
2. *Three Taxes, Three Neutralities* 851
IV. A NEW UNDERSTANDING OF TAX 854
A. *Two Norms* 856
1. *A Note on Reflective Equilibrium* 856
2. *The Norms of Capital* 859
B. *Two Uses of Capital* 863
1. *An Untypical Picture of a Typical Life* 864
2. *Smoothing Transactions* 865
3. *Shifting or Enhancing (Diminishing) Transactions* 870
C. *Progressivity* 873
D. *Debt, Again* 878
E. *Vickrey's Cumulative Lifetime Averaging, Compared* 880
V. IN PRACTICE: THE MESS WE'VE MADE, PART ONE — THE INCOME TAX 885
A. *Structural Gaps* 886
1. *Tax Planning 101* 888
2. *An Example* 891
3. *The Practical Facts of the Matter* 892
B. *Ad Hoc Deviations* 899
1. *Retirement Savings* 900
2. *More and More* 902
C. *Tax Shelters and the Noble Failure of TRA 86* 903
1. *Some Quick and Dirty Examples* 905
2. *What TRA 1986 Did, and Did Not, Do* 907
VI. THE MESS WE'VE MADE, PART TWO: BEYOND THE INCOME TAX 909
A. *Payroll Taxes* 910
B. *Death — to the Rescue?* 913
C. *Corporate Taxes Too* 917
D. *State and Local Taxes* 919
E. *Summing Up: A Voluntary Tax* 920
VII. THE FAIR TIMING OF TAX 920
A. *A Better, If Less Sophisticated, Argument* 921
B. *Transitions, Implementation, and Objections* 927
1. *Implementation* 927
2. *The Role of Other Taxes* 927
3. *The New Achilles Heel* 929
4. *Capital as Power* 930
5. *Transitions* 932
C. *Common Errors About Income and Consumption Taxes* 933
1. *We Have an Income Tax* 933

2. *The Principal Choice in Comprehensive Tax Policy Is Between an Income and a Consumption Tax* 934
3. *Consumption Taxes Are Flat Taxes* 934
4. *All Consumption Taxes Are Created Equal* 934
5. *Consumption Taxes Do Not Reach the Yield to Capital* 934
6. *The Best Argument for a Consumption Tax Is One of Horizontal Equity* 934
7. *The Case for Consumption Taxation Is One About the Importance of Capital, on the Individual or Aggregate Level* 935
8. *Rates Would Have to Increase Under a Transition to a Consumption Tax* 935
9. *The Gift and Estate and Corporate Income Taxes Are Important Backstops to the Individual Income Tax* 936
10. *Adopting a Consumption Tax Would Be a Radical Change* 936

D. *Tax Matters* 936

> To tax the sum invested, and afterwards to tax also the proceeds of the investment, is to tax the same portion of the contributor's means twice over. The principal and the interest cannot both together form part of his resources; they are the same portion twice counted; if he has the interest, it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet, because he can do either of the two, he is taxed as if he could do both, and could have the benefit of the saving and that of the spending, concurrently with one another.[1]

I. INTRODUCTION

A. *Loomings*

Perhaps we should blame it all on Mill. A great deal and possibly all of the mind-numbing complexity of America's largest and least popular tax follows from the decision to have a progressive personal income tax.[2] Proponents wanted an individual income tax notwithstanding — indeed, in large part because of — such a tax's

1. JOHN STUART MILL, 5 PRINCIPLES OF POLITICAL ECONOMY, ch. II, § 4, at 179-80 (Jonathan Riley ed., Oxford University Press 1998) (1848).

2. *See* EDWARD J. MCCAFFERY, FAIR NOT FLAT, at 1 (2002) [hereinafter MCCAFFERY, FAIR NOT FLAT] ("[O]ur tax system is a disgrace . . . . complicated, inefficient, and unfair."); Greg M. Shaw & Stephanie L. Reinhart, *The Polls — Trends: Devolution and Confidence in Government*, 65 PUB. OPINION Q. 369, 382 (2001) (poll results from 1999 showing that a plurality chose the "federal income tax" as the "worst tax, that is, the least fair").

"double taxation" of savings. This double-tax argument is an analytic point generally attributed to Mill's classic 1848 treatise, *Principles of Political Economy*.[3] Historically, much of the support for the Sixteenth Amendment, ratified in 1913, came from Southern and Midwestern, progressive, agricultural interests, who wanted, in general, to implement a redistributive tax and, in particular, to collect some tax from East Coast financiers.[4] After all, the Supreme Court had ruled that the income tax of the late nineteenth century was unconstitutional only insofar as it fell on the fruits of capital; no constitutional amendment would have been necessary to retain or implement a national wage or sales tax.[5] The legal *raison d'etre* of the income tax was to get at such returns to savings as dividends and interest.

To this day, liberals and moderates insist on retaining the structure of an income tax precisely because it gets at the returns to saving in addition to labor earnings.[6] Consumption taxes of all sorts are set in contrast to the income tax, on another side of a great divide, as taxes that fail to get at the yield to capital — that deliberately avoid Mill's "second" tax.[7] Prominent commentators on the case for consumption

3. MILL, *supra* note 1.

4. For some among several good sources of the political history, see SHELDON D. POLLACK, THE FAILURE OF U.S. TAX POLICY 45-53 (1996); ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX (1993); and Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238 (2003) (reviewing EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002)). *See also* KEVIN PHILLIPS, WEALTH AND DEMOCRACY (2002). Another and somewhat related reason to go with an individual income tax was the failure to think through the possibilities of a progressive consumption tax; this failure of imagination was understandable, given the relatively low dollar stakes involved, and the lack of both theory and real-world experience pertaining to large comprehensive tax systems. *See* STEVEN WEISMAN, THE GREAT TAX WARS (2002); Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes,"* 33 ARIZ. ST. L.J. 1057 (2001).

5. *See* Pollock v. Farmer's Loan & Trust Co., 157 U.S. 429 (1895), *modified by* 158 U.S. 601 (1895).

6. *See*, *e.g.*, MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX (1997); LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE (2002); Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363 (1996); Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261 (2002); *see also* BILL BRADLEY, THE FAIR TAX (1984).

7. *See, e.g.*, Noel B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 17 (1996) ("Both bases include consumption; the difference is that an income tax also includes changes in wealth, or savings. Whether or not it is appropriate or desirable to tax savings has been at the core of the debate."); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 961 (1992) ("Under a plausible set of assumptions, the two forms of consumption tax — a tax on consumption only and a tax on wages only — impose an equivalent tax burden in present value terms."). David A. Weisbach & Joseph Bankman, *The Superiority of a Consumption Tax Over an Income Tax* (draft on file with author) ("The only difference between an income tax and a consumption tax and hence the only issue governing the choice between the two tax systems is the taxation of the riskless return to savings."). A particularly clear statement of the traditional

taxation — both those in favor and those opposed — continue to cite, as the "best" or "most sophisticated" argument for adopting a consumption-based tax, the analytic facts that consumption taxes do not overly burden capital or its yield, and as such do not distort the savings-consumption decision, or, equivalently, do not favor present over deferred consumption.[8] The literature for and against consumption taxation is strewn with stock "horizontal equity" models, comparing savers and spenders, Ants and Grasshoppers: the idea is that income taxes punish savers, like the mythical Ant, vis-à-vis spenders like her friend Grasshopper.[9] On the other side of the great divide, supporters of redistributive taxation argue that retaining an income tax base is a central task of maintaining or obtaining fairness in tax in large part because it, alone, gets at the return to capital, the nearly exclusive province of the economically fortunate.[10]

The idea that income taxes and only income taxes effectively get at the yield to capital, and, as explained further below, that consumption taxes of either of two broad types, prepaid and postpaid, do not, constitutes the traditional view of tax.[11] The traditional view has

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view comes from the recent philosophical tract by Liam Murphy and Thomas Nagel: "This equivalence allows us to say, furthermore, that any consumption tax scheme, in taxing not accretions to wealth as such, but rather only consumption, exempts from taxation normal returns to investment." MURPHY & NAGEL, *supra* note 6, at 101; *see also* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 231-34 (2d ed. 2000). Of course, most of these fine scholars note the assumption of flat, constant, or proportionate rates. *See*, *e.g.*, Fried, *supra* note 7, at 961 n.2. A way to understand the present Article is that it takes seriously the idea of *nonconstant* tax rates, and attempts to build a normative theory around them, taking the tax rates themselves as the prior, foundational commitment of tax. This proposed rearrangement in the political epistemology of tax is a central theme of this Article.

8. *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) [hereinafter Andrews, *Personal Income Tax*]; *see also* DAVID F. BRADFORD ET AL., U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984); Fried, *supra* note 7, at 963; Mark Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649 (1983).

9. *See, e.g.*, Joel B. Slemrod & William G. Gale, *Overview*, *in* RETHINKING ESTATE AND GIFT TAXATION 1, 30-32 (William G. Gale et al. eds., 2001); C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 10 (2004). For deep critiques of the horizontal equity norm, see Thomas D. Griffith, *Should "Tax Norms" Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115, 1155 ("Horizontal equity is, perhaps, the most widespread norm underlying traditional tax policy analysis. It is also the least helpful. [It] cannot provide the answer to [any] . . . important tax policy question."); and Louis Kaplow, *Horizontal Equity: Measures in Search of Principle*, 42 NAT'L TAX J. 139 (1989).

10. *See, e.g.*, Bank, *supra* note 4 at 2256-58.

11. At least the "traditional view" as referred to within the mainstream of legal academic discourse, and in the law school classroom. The economics profession has typically had a more sophisticated, nuanced perspective. *See, e.g.*, William M. Gentry & R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, 11 TAX POL'Y & ECON. 1 (1997) [hereinafter Gentry & Hubbard, *Distributional Implications*]; Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477 (1994); Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT'L TAX J. 789 (1994) [hereinafter Kaplow, *Taxation and Risk Taking*]. Even the economics

extended well beyond the academy to influence the popular understanding of tax and its possibilities, as well as practical political decisionmaking. This traditional view has generated an impoverished choice set for tax, consisting of a badly flawed status quo on the one hand and a flat consumption tax of some sort on the other. Under the guiding light of the traditional view, we are heading ever closer towards a flat wage tax.

The traditional view is wrong.

This Article sets out a new understanding of tax. The key insight is that the canonical understanding of consumption taxes changes under consistently progressive tax rates.[12] No longer are prepaid and postpaid consumption taxes — taxes on wages and spending, respectively — equivalent. Postpaid consumption taxes can and do burden the yield to capital, and not in an arbitrary, random way. Far from it: A progressive postpaid consumption tax emerges as the fairest and least arbitrary of all comprehensive tax systems, precisely because it chooses to make its decisions about the appropriate level of progressivity at the right time. In doing so, it burdens some but not all uses of capital and its yield, and for normatively attractive reasons. These points follow from a simple statement of the analytics of tax.

This then raises an obvious question from the start: Why has the traditional view persisted for so long, virtually unchallenged? It is true enough that an ideal income tax including all sources of income — both labor earnings, or the yield to human capital, and savings, or the yield to financial capital — is a "double tax" on savings that burdens

literature, however, refers to the prevalence of the standard view, *see, e.g.*, Gentry & Hubbard, *supra*, at 5 n. 4 (referring back to Mill), and also typically suffers some limitations in its analysis and recommendations on account of the continued prevalence of this view.

12. A word on terminology is in order. What matters for most purposes for claims of justice is progressive average or (equivalently) effective tax rates, wherein taxes as a percent of total income (or consumption, or wealth, or whatever the base might be), rise in that base. *See* A. B. ATKINSON, PUBLIC ECONOMICS IN ACTION: THE BASIC INCOME/FLAT TAX PROPOSAL (1995); Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377 (1992) [hereinafter Bankman & Griffith, *Debate*]; Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987) [hereinafter Bankman & Griffith, *Social Welfare*]; Marcus Berliant & Paul Rothstein, *Possibility, Impossibility, and History in the Origins of the Marriage Tax*, 56 NAT'L TAX J. 303 (2003); James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971); MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 78-87. The United States tax system relies, and has always relied, on progressive marginal tax rates. This is one but not the only means to progressive average taxation; a better way, per the optimal tax tradition, is to rely on relatively flat, even declining marginal tax rates, coupled with a "demogrant" or lump-sum transfer to effect progression. *See* Bankman & Griffith, *Social Welfare*, *supra* at 1967; Mirrlees, *supra*; Joel Slemrod, *Optimal Tax and Optimal Tax Systems*, 4 J. ECON. PERSP. 157 (1990). For the most part, this Article, following traditional tax policy discussions, shall conflate progressive marginal and effective taxation; later it shall comment on how the new understanding of tax ought to change the analysis of progressivity, too.

savers relative to spenders. This is accurate both within the income tax's own framework, in which savers are treated more harshly than spenders, and also compared to a hypothetical no-tax world, with the income tax destroying the pretax financial equivalence between present and deferred consumption.[13] It is also analytically correct that a prepaid, yield-exempt, or (all equivalently) wage tax categorically exempts the yield to savings, preserving the relation whereby savers and spenders under normal circumstances have equal material resources in present value terms. But under progressive tax rates, a postpaid, cash-flow, or (all equivalently) spending tax is not equivalent to a yield-exempt or wage tax; that is, it is not equivalent to an "income" tax with a zero rate of taxation on savings, which is itself a semantic paradox.[14] This is a point that the traditional tax-policy literature has sometimes stated, but only in a passing manner.[15]

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13. Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 933-36 (1975).

14. William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461, 461 n.2 (1977) ("The choice between income and expenditure can be regarded as a timing question because an expenditure base can be thought of as income minus a deduction for savings, and a deduction for savings can in turn be regarded as a deferral of tax on the income set aside as savings. . . . The choice [of income or consumption taxation] can also, and for some purposes more usefully, be thought of as a zero tax rate on the income from invested savings." (citations omitted)).

15. An especially good statement of the qualification in the traditional view comes from Anne Alstott, in her response to some of my earlier work. *See* Alstott, *supra* note 6. Alstott first sets out the traditional view, stating:

> The defining characteristic of a consumption tax is that it removes from the tax base income that is saved or invested (for example, in financial instruments like stocks or bonds or in real investments like plant or equipment). A consumption tax, by definition, taxes only income spent on current, personal consumption (for example, on cars, food and travel). By deferring tax on saved income until the money is spent, a proportional consumption tax essentially exempts the earnings on investment from taxation. A progressive consumption tax of the kind Professor McCaffery advocates would offer significant tax benefits to savers while penalizing those with high levels of consumption spending.

Id. at 364-65 (footnote omitted). Professor Alstott adds a footnote explaining (in more detail than typical of the literature) the relevance of rates:

> A *proportional* consumption tax exempts from tax the income from savings. . . . This familiar "yield exemption" result holds only if tax rates are constant, however, and under a *progressive* consumption tax, the exclusion may save tax at a rate that is higher or lower than the subsequent tax rate paid on consumption. . . . In general, the tax rate on investment income will be positive where the saver faces a lower marginal tax rate than the consumer, negative where the saver faces a higher marginal tax rate than the consumer and zero where the two marginal rates are equal.

Id. at 365 n.11. For a related point, see Slemrod, *supra* note 12, at 159. *See also* Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX L. REV. 263, 349-50 (2000).

Professor Alstott wrote these thoroughly correct analytic words on the occasion of a symposium on some of my earlier articles, after considering my own reply to criticisms, part of which follows:

> Professor Alstott likes income taxes because they capture the yield to savings. But so does a back-ended progressive consumption tax. The equivalence of the yield-exempt and the cash-flow consumption tax models depends on constant marginal rates; as I point out in my articles, this fact has led many to advocate flat-rate consumption taxes. But a progressive

On the occasions when scholars have paused to reflect over the idea that varying progressive rates destroy the equivalence of prepaid and postpaid consumption taxes, they have taken one of two subsequent turns.

Some scholars simply note that the interaction of progressive rates and a postpaid consumption tax is more or less random. They state that taxes will go up, and hence there will be a "penalty" for savers if consumption occurs in a higher rate bracket than initial earnings; taxes will go down, and hence there will be a "subsidy" for savers if consumption occurs at a lower level than initial earnings.[16] This language of subsidy and penalty is not helpful: It tends to confuse matters, perhaps because of an innate or intuitive aversion to nonneutral sounding rules, a belief that neutrality per se is an end.[17] More deeply, this first move does not take the analytical understanding of tax far enough. When savings or the yield to capital will decrease or increase a taxpayer's burden of taxation under a consistent, progressive postpaid consumption tax is not random. The burden of taxation will decrease when a taxpayer uses capital transactions (borrowing, saving, investing) to smooth out the pattern of her lifetime labor earnings, and thereby to consume, in any given year, at the level of her average annual lifetime labor earnings in constant dollar terms. The burden will also decrease when capital transactions result in diminished consumption, again measured against the average annual labor earnings as the baseline. The burden of

> cash flow or (equivalently) back-ended consumption tax consciously hits at wealth that is spent as it is spent, whether it is taken out of earnings or capital. There is no reason, dictated by political liberal theory alone, to link flat rates with consumption taxes. A progressive consumption-without-estate tax is not a consumption tax in the sense that a consumption tax never taxes the yield to capital. But I do not necessarily care about that, because no part of my analysis turned on prior definitions.

Edward J. McCaffery, *Being the Best We Can Be (A Reply to My Critics)*, 51 TAX L. REV. 615, 630-31 (1996) (footnotes omitted) [hereinafter McCaffery, *Being the Best*]. The present Article grew out of my continued thinking about the relevance of variable and progressive rates to the income-versus-consumption debate. Not only did I notice the continued iteration of the view that consumption taxes do not reach the yield to capital in the popular political culture and in tax policymaking circles, but I also came to see that my own earlier work was incomplete in that I had not developed a suitably general theory of how, precisely, varying rates affected the choice of tax base, and of the normative basis for the argument. In time, I came to see that the reason for the repetition of the traditional view was having the wrong argument structure supporting a consistent consumption tax, a theme throughout this Article. Working on these issues over several years led to the present Article.

16. *See*, *e.g.*, Alstott, *supra* note 6, at 386-87; William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 954 (1975) [hereinafter, Andrews, *Reply to Professor Warren*]; Warren, *supra* note 13, at 940-51.

17. *See*, *e.g.*, Edward J. McCaffery & Jon Baron, *Framing and Taxation: Normative Evaluation of Tax Policies Involving Household Composition*, 25 J. ECON. PSYCHOL. 679 (2003) (discussing, *inter alia*, experimental results showing a "neutrality bias"); *see also* Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 TAX. L. REV. 163, 229 (1993) (criticizing naive neutrality norms in tax policy scholarship).

taxation will increase when capital transactions are used to finance enhanced, or greater, consumption than this level. This pattern is not random, as this Article demonstrates.

Other scholars point out that the potential nonequivalence of the two consumption taxes leads to an argument for flat or proportionate consumption tax rates, because they presume — or presume that consumption tax supporters presume — that the best argument for a consumption tax is one of preserving the "neutrality" between savers and spenders, or of avoiding Mill's second tax, or, other times, of promoting savings on an individual or social aggregate level.[18] This move puts the cart before the horse: it rests the case for consumption taxation on weak normative foundations. To counter this move, we need to explore portions of the intellectual history of tax so as to develop new arguments for old ideas. It turns out that the best argument for a consumption tax of the right sort is not a simple horizontal equity argument at all, as this Article develops.

The new understanding of tax embraces three, not two, choices of comprehensive tax bases.[19] A consistent, progressive postpaid consumption tax stands between an income tax, which double taxes all savings by including the yield to capital in its base, and a prepaid consumption or wage tax, which never taxes the yield to capital. A consistent, progressive postpaid consumption tax burdens some but not all of the yield to capital, and does so in a principled way, by design. There is no need for ad hoc deviations from an analytically sound understanding of the comprehensive tax ideal to achieve the result, as there is, for an important example, under the "income" tax so as to remove the double-tax sting from retirement (or medical or education-related) savings. A progressive postpaid consumption tax relatively lightens taxation on the use of capital transactions to move uneven labor market earnings into even cash flows in constant dollar terms. But the very same tax falls more heavily on the use of capital transactions to increase one's lifestyle above this level. There is nothing arbitrary about this.

This analytic theme of the new understanding of tax opens the way for a rethinking of the normative grounding of tax. A consistent, progressive postpaid consumption tax is appealing, in part precisely because it corresponds with widely held and independently reasonable ordinary moral intuitions in regard to the taxation of capital and its

18. For a good example, see Warren, *supra* note 13, at 934-41 (responding to Andrews, *Personal Income Tax*, *supra* note 8). Warren saw clearly that "[t]he only relevant difference between a consumption-type personal income tax and a wage tax is thus the disparity that arises when tax rates are not constant." But he went on to argue, on account of Andrews's "most sophisticated" argument for consumption taxation, that this fact argued against progressive rates.

19. *See* Edward J. McCaffery, *Three Views of Tax*, 18 CAN. J.L. & JURISPRUDENCE 153 (2005) [hereinafter McCaffery, *Three Views*].

yield. To be clear, this is not the only, or even necessarily the best argument for a consistent, progressive postpaid consumption tax: Writing on a blank slate, one might simply cut to the chase and argue that this tax is the fairest, most efficient, and simplest to administer of any comprehensive tax plan.[20] But history and a considerable amount of tax-policy scholarship, at least since Mill, have conflated the case for consumption taxes of any sort with the case against taxing some or all of the yield to capital. Given that this is where matters stand, it becomes important to see that, among all the major alternatives, a progressive postpaid consumption tax best gets at the yield to capital in just the way that ordinary moral intuitions seem to want to get at such yield. The most decisive evidence for this claim comes from an examination of a near century of experience with tax. Looking at tax policy through the lens of the new understanding of tax, with its three, not two, types of tax, we can see that the actual income tax is not an income tax at all because it is inconsistent in its taxation of the yield to savings. But this inconsistency is not without principle. We can see the income tax attempting to differentiate between "ordinary" savings that effectuate smoothing and all else. Coining two further normative terms, the new understanding refers to the idea that those savings that are used to even out cash-flows, such as retirement savings, should not be double taxed as the "ordinary-savings" norm, and refers to the idea that the yield to capital is an increment of value that ought to bear some tax as the "yield-to-capital" norm. The uneasy coexistence of these two norms under the income tax has led to incoherence, inefficiency, and unfairness. But the two norms, by design, come into perfect harmony under a consistent, progressive postpaid consumption tax.

The best argument for a postpaid consumption tax is not, therefore, about the "horizontal equity" of savers and spenders, or about the principled nontaxation of the yield to capital. It is not an argument about the aggregate capital stock, or even about the importance of savings on individual or national levels: depending on the choice of tax rates, we can have more, less, or the same amount of savings under a consumption as under an income tax. Rather, the best argument for a consistent, progressive postpaid consumption tax is that the moment of actual consumption represents the best — namely, the fairest and most efficient — time to make the decisions about the appropriate level of taxation, in large part because this allows us to get to some but not all of the yield to capital: only that yield which enhances lifestyles, and no other.

20. This is what I have attempted to do in *Fair Not Flat*. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2.

In all this, I more or less posit that progressivity — getting the better able-to-pay to pay more, to some degree, than the less able — is an attractive end for tax. I shall say a few words about this end later. But for the most part, I presume that we want a progressive, redistributive tax system.[21] Partly, this is a matter of ordinary moral intuitions and our collective history, as I read them, as well as independent political and moral theory. But it is also analytic. Under a flat-rate tax, prepaid and postpaid consumption taxes are indeed largely equivalent, and neither reaches the yield to capital.[22] If we do not want progressive tax rates, many far simpler alternatives to the status quo are available; if we do not want to reach the yield to capital, ever, then we can choose a prepaid or a flat-rate postpaid consumption tax. I proceed on the assumption that "we" — at least a good many contemporary citizens and readers — do want progressivity and some taxation of the yield to capital, and in fact that these ends are prior to any preference over more particular forms of taxation. I write to show that a progressive postpaid consumption tax is the best — indeed, the only practicable — way to obtain these goals.

The new understanding of tax paves the way for extensive tax reform and opens up an important line of critique on current political proposals. The real and pressingly practical question for tax is not whether to have an income or a consumption tax, but what form of consumption tax to have. The stakes in this battle are clear and dramatic: the fate of progressivity in tax lies in the balance. Contemporary conservative leaders have signaled a desire to move tax towards a prepaid consumption tax. Such a tax, falling exclusively on wages, jeopardizes America's historic commitment to at least moderate progression in the distribution of tax burdens. The path towards maintaining that commitment lies in taxing at the opposite

21. There are, of course, compelling moral and political theoretic arguments for progressivity. *See* HARVEY ROSEN, PUBLIC FINANCE (6th ed. 2002); Andrews, *Reply to Professor Warren*, *supra* note 16; Bankman & Griffith, *Social Welfare*, *supra* note 12; Fried, *supra* note 7; STEUERLE, *supra* note 9. I also largely accept the argument of Louis Kaplow and Steven Shavell, tracking the two welfare theorems, that the general legal system should be evaluated vis-à-vis the goal of welfare maximization or allocative efficiency, leaving the tax system to redistribute wealth. *See* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002). But this sensible bifurcation of normative labors puts more pressure on getting progressivity in tax down right. *See* Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution,* UCLA L. REV. (forthcoming Aug. 2005); *see also*, Jonathan Baron & Edward J. McCaffery, *Masking Redistribution (or Its Absence)*, *in* BEHAVIORAL PUBLIC FINANCE (Edward J. McCaffery & Joel Slemrod, eds., forthcoming 2005). In fact, most Americans support the notion of progressivity and oppose a flat tax. *See* Will Lester, *Poll: Americans Say Taxes Too Complicated*, Associated Press, Apr. 12, 2005, *available at* http://staging.hosted.ap.org/dynamic/stories/T/TAXES_AP_IPSOS_POLL?SITE=AP&SECTION=HOME&TEMPLATE=DEFAULT&CTIME=2005-04-11-14-49-05 (noting that 57 percent of respondents to AP poll oppose a flat tax regime, while only 40 percent support it).

22. *See infra* Part II.C.

time, of ultimate outflow, not inflow — which the postpaid consumption tax model, alone among major alternatives, does. It is time to get the fair timing of tax down right.

The rest of this Article makes good on these opening claims.

B. *The Road Ahead*

Reconsidering tax policy more or less from the ground up has its advantages, for the traditional view has made certain wrong turns along its way. Thus, an intellectual history merges with an analytic discussion of tax to generate a critique of the status quo on the way to a specific programmatic proposal for normative improvement. Here is a brief summary of the path through the argument.

Part II sets out the traditional understanding of the income and both forms of consumption taxes.

Part III begins to translate the analytic facts of tax into a normative theory. It explores some of the intellectual history of tax to lay the foundation for a reconceived normative argument structure.

Part IV introduces a new vocabulary and analysis to support the new understanding of tax. Most importantly, it develops more formally two norms about the taxation of capital: the yield-to-capital norm, which holds that the return to capital is an increment of value that ought to be taxed, and the ordinary-savings norm, which holds that savings that merely shift labor earnings within a lifetime or between taxpayers ought not to be excessively burdened. These two norms are in fatal tension under an income tax; in contrast, a consistent, progressive postpaid consumption tax accommodates both norms by design.

Part V begins to look at and critique contemporary practice by explaining that, in reality, the so-called income tax is effectively a prepaid consumption or wage tax.

Part VI continues the examination of tax practice beyond the income tax. The overall skew of the present system towards wage and away from capital taxation becomes more dramatic when other taxes join the mix.

Part VII completes the journey by arguing that the right choice is a consistent, progressive postpaid consumption tax. It sets out a better argument structure for supporting this tax; notes issues of transition, implementation, and objections to the tax; and points out how the new understanding of tax underscores some persistent errors in the popular understanding of tax. The Part, and the Article, concludes by noting why it all matters.

II. IN THEORY: THREE FORMS OF TAX

There are three major choices of broad-based tax systems in ideal theory: the income tax, and prepaid and postpaid consumption taxes.[23] The traditional view of tax has contrasted the income tax with both forms of consumption tax, which forms it has equated. But the traditional view has gone awry in overlooking some of the lessons from the analytics of tax. The new understanding turns on the uniqueness of each of the three forms of tax. It is worth beginning with the basics.

A. *An Example*

A simple numeric example helps to illustrate the more technical discussion to follow.

Suppose that Ant and Grasshopper each earn $200 in wages, the tax rate is 50 percent (for simplicity), and the interest rate on savings is 10 percent.

Grasshopper, as is his way, spends all of his available money at once. Under any tax — income, prepaid or postpaid consumption — the government takes its 50 percent cut, or $100, and Grasshopper consumes the remaining $100. This illustrates an important point: A good deal of this discussion has no direct impact on most Americans for the simple reason that they do not save.[24] Income is consumption for those who do not save.[25]

Ant, in contrast, does save, as is her way. The choice of tax does matter to her. Suppose Ant saves for two years, at the conclusion of which she consumes all that she has amassed. How do the three different taxes treat her?

An income tax reduces Ant's $200 to $100 right away, which she puts in the bank. Ant earns 10 percent on her savings, or $10, in Year 1, but the income tax taxes this, too — Mill's double tax — taking

23. This is before bringing transaction costs into the story, which push the income tax to an income-with-realization tax, and generate other types of "hybrid" taxes. Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992) [hereinafter McCaffery, *Hybrid*]. *See* discussion in Parts V and VI, *infra*. Part of the argument of this Article is that *unprincipled* "hybrids" can lead to perverse, counter-productive results; the current hybrid income-consumption tax, for an important example, ends up being a prepaid consumption or wage tax. *See infra* Part V. A consistent progressive postpaid consumption tax, in contrast, is mixed in its effects on capital on the individual level, as I argue throughout, but is not a "hybrid."

24. This is not to say that the subject does not matter indirectly, of course; the savings and consumption behavior of the wealthy affect the whole society. *See* Edward J. McCaffery, *Must We Have the Right to Waste?*, *in* NEW ESSAYS ON THE LEGAL AND PHILOSOPHICAL UNDERSTANDING OF PROPERTY 76 (Stephen R. Munzer ed., 2001) [hereinafter McCaffery, *The Right to Waste?*].

25. *See infra* Part II.B (explaining the Haig-Simons definition of income).

away $5, leaving her with $105 at the end of Year 1. In Year 2, this $105 again earns 10 percent, or $10.50; again the income tax strikes, taking $5.25; this leaves Ant with $110.25 to consume at the end of Year 2. If the 10 percent interest rate simply compensated Ant for inflation — if the cost of goods were rising at 10 percent per year — Ant would be losing real value, or actual purchasing power, over time under the income tax: $110.25 at the end of two periods of 10 percent inflation is worth — that is, has the same real purchasing power as — $91 at the start of the two periods.[26]

Consider next the two forms of consumption tax. First, the prepaid model: Ant is taxed right off the bat under this system, reducing her $200 to $100. But she is not taxed again: consumption taxes are single taxes, escaping Mill's double-tax label. The $100 grows by the full 10 percent interest rate, to $110, after Year 1. In Year 2, the $110 grows another 10 percent, or $11, to $121, and Ant is left to consume this much at the end of Year 2. Unlike the case with the income tax, this end of Year 2 consumption is worth the same as $100 at the start of Year 1, under a 10 percent inflation rate.

Under the postpaid consumption tax model, Ant can save her entire $200 because she pays no tax up front. This grows by 10 percent, or $20, in Year 1, to $220. The $220 grows by another 10 percent, or $22, to $242, in Year 2. When Ant goes to consume this, the government collects its 50 percent share, leaving Ant with $121 to consume. The result is equivalent to that under the prepaid model. And what Ant has left is more than what is left over under an income tax. There are no smoke and mirrors here. There are only two critical assumptions needed to make out the equivalence of prepaid and postpaid consumption taxes: that the interest and tax rates have stayed constant in the two periods.[27]

Table 1 summarizes the example. Grasshopper's consumption at the start of Year 1, set out in the first column, is constant at $100. Ant's potential consumption at the end of Year 2, set out in the middle column, is $110.25 under an income tax and $121 under either form of consumption tax. The final column converts these values back into constant initial Year 1 dollars, at a 10 percent discount/interest rate. This conversion makes clear that, under constant rates, savers lose real value under a true income tax, whereas a constant-rate consumption tax is "neutral" as between savers and spenders, present and deferred consumption.

26. The real purchasing power at the start of the two periods is equal to $110.25/(1+r)^2 = 110.25/1.21 = 91$.

27. See *infra* Part II.D for further discussion of these assumptions.

TABLE 1: INCOME, PREPAID AND POSTPAID CONSUMPTION TAXES COMPARED

	Grasshopper	Ant	
Tax	Year 1 Consumption	Year 2 Consumption	Value in Year 1 $
Income	$100	$110.25	$91
Prepaid Consumption	$100	$121	$100
Postpaid Consumption	$100	$121	$100

The Ant-Grasshopper example stands at the center of the traditional view of tax. The income tax is a double tax on value that is not immediately consumed, which has led many conservatives to oppose it as an unfair burden on the noble Ant, but liberals to support it as a necessary means of capturing some of the return to capital — a benefit that inures almost exclusively to the wealthy. Both forms of consumption tax get put on the other side of a great divide, as not reaching the yield to capital. It becomes a matter of either indifference or administrative convenience which of the two forms is chosen.[28]

B. *The Income Tax*

This and the following sections present the analytics of the income and consumption taxes more formally than the numeric example of Ant and Grasshopper. The formal analysis helps to reveal some more subtle points.

Traditional income tax theory begins, and sometimes ends, with the Haig-Simons definition of income.[29] Simons took many more words to get the idea across, but his definition is a very simple identity, stating in essence that:

$$\textit{Income} = \textit{Consumption} + \textit{Savings}. \quad [1]$$

28. Like many elements in the traditional view, Andrews was among the first best spokespersons for this idea. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1114-19; *see also* BRADFORD ET AL., *supra* note 8, at 10; SLEMROD & BAKIJA, *supra* note 7, at 221-22.

29. The definition is named after Henry C. Simons and Robert Haig who, along with several others, derived it independently. Robert Murray Haig, *The Concept of Income — Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 7 (Robert Murray Haig ed., 1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (photo reprint 1980) (1938) ("Income may be defined as the algebraic sum of the market value of rights exercised in consumption plus the change in value of the store of property rights between the beginning and end of the period in question.").

This is no more and no less than the accounting truth that:

Sources = *Uses*, [1a]

or, even more simply, the truism that:

All Income is either spent (Consumption), or not (Savings). [1b]

This is not profound. But simple principles often underlie complex structures. The Haig-Simons definition of income has been enormously influential in analyzing tax. An especially common use of the definition of income has been to show, by rearranging terms, that a consumption tax does not include savings in its base, while an income tax does:

Consumption = *Income* - *Savings*. [2]

The idea here is simple. Since all you can do with your available wealth is spend it or not (Equation [1b]), and since what you do not spend you save — by the semantic definition of "saving" — the government can come up with any particular taxpayer's consumption for any given period simply by subtracting savings from income. If you know two components of an identity relationship involving three terms, the third can be derived. This leads to the important practical point that a postpaid consumption tax need not proceed along an administrative line requiring tallying up precise consumption items; subtracting savings from income will do the trick perfectly well. Hence, a postpaid consumption tax is sometimes called a "consumed income tax," blurring the ideal distinctions, while attempting to mute opposition to the "consumption" tax label.[30] Traditional individual retirement accounts (IRAs) and qualified pension plans work this way: as subtractions from (or noninclusions in) what would otherwise be "income."[31] The unsaved portion of income is — by definition — consumed.

30. *See* David A. Hartman, *The End of Income Taxes*, CHRONICLES, May 2003, at 42; Laurence Seidman, *A Better Way to Tax*, PUB. INT., Winter 1994, at 65; Al Ehrbar, *Consumption Tax*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *at* http://www.econlib.org/library/Enc/ConsumptionTax.html (last visited Jan. 14, 2005) ("A consumption tax — also known as an expenditures tax, consumed-income tax, or cash-flow tax — is a tax on what people spend instead of what they earn.").

31. I.R.C. § 408 (traditional IRAs) (2004); § 401 (qualified pension plans) (2004). In a qualified pension plan that works on the "defined benefit" model, the employer's contribution to the employee's plan never enters into the employee's income in the first place. This is equivalent, of course, to including the value in income and then allowing a deduction for savings.

Mill's criticism of the income tax, quoted in the opening epigraph and discussed in greater detail below, is that any income tax is a "double" tax on savings. To understand this point analytically, consider the basic financial equation defining the future value (*FV*) of a present value (*PV*) invested over time (*n*) at any given interest rate, (*r*):

$$FV = PV\ (1 + r).^{n}\ [3]$$

This is a simple relation. Recall the case of Ant. She saved the sum of \$100 for two periods at an interest rate of 10 percent, or .10, per period. After one period, the \$100 grew to (100)(1 + .10), or \$110. In the second period, this \$110, that is (100)(1 + .10), again grew by 10 percent, becoming $(100)(1 + .10)(1 + .10) = (100)(1 + .10)^2 = \$121$. And so on.

Consider what happens when the government imposes a tax. A tax takes t away from a taxpayer, leaving her to keep $(1 - t)$.[32] Suppose for example the tax rate were 30 percent; the government would take this, leaving the taxpayer with 70 percent of whatever was being taxed. A fundamental principle of economic "neutrality" is that tax should not distort the nontax allocation of resources or the relative price system.[33] So we would expect, in a "neutral" tax world, as a first cut, that Equation [3] would become:

$$(1 - t)\ FV = (1 - t)\ PV\ (1 + r).^{n}\ [4]$$

At a 30 percent tax rate, Equation [4] illustrates the fact that a taxpayer keeps 70 percent of her initial resources. By multiplying each side of Equation [3] by .7, the equality is maintained.

The problem that Mill identified was that an income tax is not neutral, because it falls again on the yield to capital, or $r(PV)$ in Equations [3] and [4]. An income tax looks like the right-hand side of the equation below:

$$(1 - t)\ FV > (1 - t)\ PV\ (1 + (1 - t)\ r).^{n}\ [5]$$

The income tax is not neutral because two minus *t*s appear on the right hand side of this equation. The left-hand side of this relation,

32. In these examples, for simplicity, the text uses a single flat-rate tax. But nothing of any consequence changes if one imagines instead a vector of taxes, as befits the step function approach to tax rates found in today's income tax. *See infra* Part IV.C.

33. Don Fullerton & Yolanda Kodrzycki Henderson, *The Impact of Fundamental Tax Reform on the Allocation of Resources*, *in* THE EFFECTS OF TAXATION ON CAPITAL ACCUMULATION 401 (Martin Feldstein ed. 1987); Don Fullerton & Diane Lim Rogers, *Neglected Effects on the Uses Side: Even a Uniform Tax Would Change Relative Goods Prices*, 87 AM. ECON. REV. 120 (1997).

that imposes a single tax on the *FV* of Equation [3], is no longer equal to the right-hand side as it had been under the "neutral" tax system posited in Equation [4]. What is actually left by the income tax — the right-hand side of Equation [5] — is less than this amount. The "=" sign of Equation [4] must now become a ">" sign. This is what Table 1 had shown, using the canonical Ant-Grasshopper example: Income taxes hurt savers compared to nonsavers.

C. *Two Forms of Consumption Tax*

The same equations just set out also illustrate the broad equivalence of the two basic forms of consumption taxation. Consider again Equation [4]:

$$(1 - t)\ FV = (1 - t)\ PV\ (1 + r).^n \quad [4]$$

This equation had set out the "neutral," or *one tax*, condition: in order to maintain the equivalence of present and future values for a given increment of wealth, a single tax ought to be levied on the flow, however long the underlying wealth persists in the taxpayer's hands. Now it does not matter, under the commutative principle of multiplication (which holds that $ab = ba$), where, or, better put, when, one levies the consumption tax's single tax. That is:

$$(1 - t)\ FV = \{(1 - t)\ PV\}\ (1 + r)^n = \{PV\ (1 + r)^n\}(1 - t). \quad [6]$$

The middle form of consumption taxation in Equation [6], where the minus t is levied up front, is the prepaid or yield-exempt model.[34] It is, in essence, a wage tax, like social security. The single tax is levied when dollars are first earned — the $(1 - t)$ is applied to the *PV* — and never again. One does not pay a "second" social security tax on dividends and interest; the yield to capital is exempt. The recently added "Roth" IRAs work this way, and contemporary proposals from the Bush Administration would move tax policy even more decisively in this direction.[35]

The second form of consumption tax, where the minus t is levied on the back-end, is the postpaid, qualified account, or cash-flow model. This is how traditional IRAs and qualified pension plans are taxed under the so-called income tax. More simply, it is like a sales tax. You do not pay taxes when money is first earned: the $(1 - t)$ lies in wait to apply to a bigger nominal sum later on down the road. Under

34. *See* BRADFORD ET. AL., *supra* note 8, at 31-33.

35. I.R.C. § 408A (2004) (Roth IRA); *see also* John Cassidy, *Tax Code*, NEW YORKER, Sept. 6, 2004, at 70 (discussing contemporary proposals from Bush Administration).

the current income tax, you get a deduction (or noninclusion) for contributions to an IRA or a pension plan (or for the employer's contribution thereto). You pay the single tax when the money is withdrawn, in the case of a pension plan, or actually spent, in the case of a literal sales tax.

The dramatic insight is that the two taxes are — or can be — the same, as in the simple Ant-Grasshopper example summarized in Table 1. Equation [6], relying only on the commutative principle of multiplication, shows this fact more formally.

D. *Two Conditions of Equivalence*

Equation [6], and thus the equivalence of the prepaid and postpaid consumption taxes — of wage and sales taxes — holds under just two seemingly innocuous conditions, constant tax rates and constant rates of return.

1. *Constant Tax Rates*

The tax rate, t, must be the same in the two possible periods of taxation — the period of first labor market earning, and the period of subsequent (in the case of any savings) consumption. To help make this clearer, Equation [7] simply restates Equation [6], showing the equivalence of the prepaid and postpaid models under the traditional view, with subscripts on the two t terms:

$$(1 - t)\ FV = \{(1 - t_1)\ PV\}\ (1 + r)^n = \{PV\ (1 + r)^n\}(1 - t_2). \quad [7]$$

This form makes more transparent the mathematical fact, which is typically assumed, that t_1 must be equal to t_2 in order for the general equivalence of prepaid and postpaid consumption taxes to hold. In the Ant-Grasshopper example, the same 50 percent tax must apply at the start of Year 1 as at the end of Year 2. In the traditional view of tax, explored here and in Part III, these analytics morph into a norm that the tax rate *should* be the same.[36] In the new understanding of tax, the analytics open up the possibilities of and hopes for deliberately variable progressive rates.

36. Warren pointed out that this should be so if Andrews's "most sophisticated" reason for preferring consumption taxation were to hold sway. *See* Warren, *supra* note 13, at 944-45. Andrews, in his 1975 response to Warren, protested this point a bit, but eventually the nuance was lost on the literature. *See* Andrews, *Reply to Professor Warren*, *supra* note 16, at 955.

2. *Constant Rates of Return*

Just as the *t* in Equation [6] must be constant, so must the *r*. This second condition, a more technical one than the first, is that there not be "windfall" or "inframarginal" returns to capital, disproportionate to the net amount of capital invested — that the rates of return do not change between the second and third terms in Equations [6] and [7].[37] It may, at first, seem intuitive that a prepaid consumption tax does not capture a windfall or lucky return in the capital markets at all, and hence a simpler statement of this second condition — that postpaid consumption taxes get at windfalls, while prepaid ones do not — is all that is needed.[38] But under a prepaid consumption tax model, there is less wealth in the taxpayer's hands to invest in the first place. If the windfall returns shrink proportionate to the reduced private capital stock occasioned by the tax, there is no technical difference between the two models, hence the added nuance. Macroeconomic or micro-level individual behavioral changes can alter the equivalence as well.[39]

A simple numeric example again helps to illustrate these technical points. Suppose that there are some investments that will yield staggering (extraordinary) returns — say that they will double one's money in a year, a 100 percent rate of return. Under a prepaid consumption tax model, recall that Ant will earn $200, pay $100 in taxes right away, and have $100 to invest. With the 100 percent rate of return available, this can grow to $200 in a single year. Under the postpaid consumption tax model, Ant will have the full $200 to invest initially and pay tax later. The question raised by this second condition is simply this: Can Ant's $200 grow to $400? If so — this is a case where the windfall return possibilities expand with the private capital

37. *See* Michael J. Graetz, *Expenditure Tax Design*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 161, 172-75, 238 (Joseph A. Pechman ed., 1980); McCaffery, *Hybrid*, *supra* note 23, at 1151 n.24; Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990) [hereinafter Strnad, *Periodicity and Accretion Taxation*]; Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 STAN. L. REV. 1023, 1056-61, 1087-88 (1985).

38. *Cf.* STEUERLE, *supra* note 9, at 241 n.4.

39. *See* Bankman & Griffith, *Debate*, *supra* note 12, at 385-86; Louis Kaplow, *Taxation and Risk Taking*, *supra* note 11; David Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. (forthcoming 2004); David M. Schizer, Scaling Up and the Taxation of Risky Investments: Derivatives and the Search for Practical Applications (Northwestern School of Law, Law & Economics Colloquium Series, Oct. 15, 2003), *at* http://www.law.northwestern.edu/colloquium/law_economics/Schizer.pdf (last visited Jan. 14, 2004); Lawrence Zelenak, Taxing (or Not) The Returns to Risk-Bearing (Dec. 17, 2003) (draft on file with author); Weisbach & Bankman, *supra* note 7. This literature points out that, with an ideal income tax with full loss offsets, the only difference between an income tax and a postpaid consumption tax is that the former includes, whereas the latter does not, the real, riskless rate of return. Once again, this analysis holds tax rates constant in its models. The current income tax has limited capital loss offsets. I.R.C. § 1211 (2004). For further discussion *see infra* Part V.C.1.

stock — the postpaid tax will collect its 50 percent on withdrawal, leaving her with $200, just as under the prepaid model with the supranormal 100 percent return. Or, instead, will Ant's "first" $100 of savings double, to $200, and her "second" $100 of savings return the "normal" 10 percent, growing to $110, leaving her with $310 total? This is the case where the opportunities for windfall returns either go to the public sector, or are in any event invariant to the net amount of private capital invested: there was just one lucky opportunity to be had, for $100, whether Ant had $100 or $200 to invest. If that is the case, the postpaid tax will collect $155, leaving her with a like amount. If this latter case occurs then the postpaid consumption tax — but not the prepaid one — will have captured at least some of the high or "windfall" returns from the capital markets; Ant will have more value to consume in the prepaid world.

E. *The Treatment of Debt*

How the two forms of the consumption tax and the income tax treat savings is widely noted and reflected in traditional tax policy doctrine, now set out in basic tax textbooks.[40] There is far less discussion and hence less understanding of the proper analytic treatment of debt. This is unfortunate, as a practical matter, because debt is of enormous consequence both in everyday life and in understanding the appeal of different tax systems. The failure to get the tax treatment of debt down right led to an analytic mistake in the design of the Nunn-Domenici USA Tax, a progressive postpaid consumption tax that almost became American law.[41] The misunderstanding is also unfortunate, for the proper analytic understanding of debt is simple enough if one merely considers debt as a form of negative savings, or dissavings.

An income tax ignores debt under the Haig-Simons definition of income in Equation [1]. There is no genuine accession to wealth — no change in one's net worth — when one borrows. The proceeds of debt will be put to one of the two basic and mutually exclusive uses of income, or some combination thereof — the money will be spent (consumed) or not (saved). In any event, the consumption, savings, or combined consumption and savings is precisely offset by the dissavings that the debt itself represents, a subtraction of *Savings* on the right-hand side of Equation [1]. Borrowing is a "wash," as tax lawyers say.

40. *See*, *e.g.*, JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 67-80 (3d ed. 2004); WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 15 (12th ed. 2000); MCCAFFERY, FAIR NOT FLAT, *supra* note 2; PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION 4-20 (5th ed. 2004).

41. *See* LAURENCE SEIDMAN, THE USA TAX (1997). *See generally* USA Tax Act of 1995, S. 722, 104th Cong. (1995).

Consistent with the ignoring of the initial incurring of debt, there is no general deduction for the repayment of the *principal* of debt: material resources are diminished by the payment, but savings or net wealth is increased by the elimination of the liability, resulting in another wash.[42]

A prepaid consumption or wage tax systematically ignores debt. This is because it only falls on labor earnings. Prepaid consumption taxes ignore all savings, negative savings included. There is no deduction for the repayment of principal or interest. One's credit history is irrelevant to the social security or payroll tax authorities.

A postpaid consumption tax, in contrast, includes debt as a taxable inflow. Recall Equation [2]:

$$\textit{Consumption} = \textit{Income} - \textit{Savings}. \quad [2]$$

A postpaid consumption tax allows a general, unlimited deduction for positive savings. Borrowing is negative savings. Subtracting a negative means adding it, so debt comes into the postpaid consumption tax base in the first instance. Debt that is used to finance present period savings, however, will come out as a wash: an inclusion qua negative savings, an exclusion qua positive savings. Debt that is used to finance consumption, on the other hand, will trigger tax in the year of consumption: only the negative savings will appear on the right-hand side. In a later period, repayments of principal and interest are fully deductible from the consumption tax base. These repayments do represent positive savings.[43]

42. The deductibility of *interest* is a separate and more complicated matter. A case can be made for deducting all interest under an income tax, because interest payments reflect neither present period consumption nor savings, but rather the compensation for consuming or saving in some other time period. *See* Alan J. Auerbach, *Should Interest Deductions Be Limited?*, *in* UNEASY COMPROMISE 195 (Henry J. Aaron et al. eds., 1988). This was indeed generally the law prior to the Tax Reform Act of 1986. I.R.C. § 163 (1982) (amended 1986); *but cf.* I.R.C. § 265 (2004) (limitation on interest deduction on debt used to acquire tax-exempt income). But because the "income" tax is not really an income tax — it looks more like a prepaid consumption tax (*see infra* Part V) — an unlimited interest deduction could literally obliterate the tax. Hence, the current law in regard to the deductibility of interest, as in many other areas, is rife with uneasy compromises. *See* I.R.C. §§ 163(a) (general rule), 163(d) (limitation of deduction of investment-related interest), 163(h) (limitation on deduction of personal interest) (2004).

43. I suspect that much of the misunderstanding of the tax treatment of debt follows from a failure to understand that zero is simply a number, merely one point on the spectrum of possible wealth. Moving from a negative net wealth to zero, or from a deeply negative position to a less deeply negative one, is an accession to wealth. So if a taxpayer is $5,000 in debt, and she pays off $1,000 of this, she has "saved" by increasing her net worth from negative $5,000 to negative $4,000. This is not analytically different from saving $1,000 to increase one's bank account from $4,000 to $5,000. But it seems a fairly durable feature of most of our thinking about financial matters that strange things happen to our understanding around zero. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Edward J. McCaffery, *Cognitive*

This sounds odd and unfamiliar, but it need not. Consider a routine sales tax, the most common form of a postpaid consumption tax. Grasshopper pays sales tax when he purchases an item, even if he is using borrowed funds to do so, as by putting the purchase on his credit card. Later when Grasshopper pays off his credit card balance, including any interest that he may have accumulated by then, he does not pay another round of sales taxes on the payment. So it would work under a broad-based, comprehensive postpaid consumption tax.

It may seem as if a postpaid consumption tax is to be disfavored on this score, but we shall see later that this is not so.[44]

III. A Problem of Understanding

The traditional view of tax opposes income to consumption taxation. A better understanding of tax shows that, under progressive rates, three distinct forms emerge: income, prepaid consumption, and postpaid consumption, each with unique positive and normative properties. This Part has two related goals. One, it canvasses some of the intellectual history of tax, to better understand where the traditional view came from and why certain misunderstandings persist. Two, it begins translating the new, better understanding of the analytic facts of tax into a normative argument structure; it helps lay the foundations for moving from an *is* to an *ought*, setting the stage for the new understanding of tax.

A. *Means and Ends*

A proper normative argument structure for tax — or any other practical political matter — ought to begin with a clear statement of the goals to be pursued, setting the ends, at least provisionally, first.[45] We can note at the start that the *form* of tax, per se, is not plausibly such an end: few ordinary persons have strong preferences for income versus consumption versus any other particular type of tax, apart from the effects of such taxes. It is these effects, of course, that matter.

On reflection, the principal end of broad-based, comprehensive tax systems is to finance the provision of public goods, the central activity of the modern democratic state, including, possibly, the distribution or

Theory and Tax, 41 UCLA L. Rev. 1861 (1994) [hereinafter McCaffery, *Cognitive Theory and Tax*].

44. *See infra* Part IV.D.

45. *See* Louis Kaplow, *A Framework for Assessing Gift and Estate Taxation*, *in* Rethinking Gift and Estate Taxation 164 (James R. Hines Jr. & Joel Slemrod eds., 2001). I write "provisionally" because subsequent analysis might reveal that the ends are not obtainable, or stand in some tension with one another, and so must be reconsidered.

redistribution of income itself, in a fair and efficient manner.[46] Fairness and efficiency are two broad, compelling ends for tax. For the most part, this Article sets aside efficiency concerns;[47] the new understanding of tax is based on the idea that there are three distinct types of comprehensive tax systems, with different claims to fairness — most specifically because of how they affect capital as well as labor market returns.

On further reflection, fairness is central to tax and not just, or primarily, because of a welfarist argument that efficiency should be the principal norm of legal rules, while fairness should be left to the tax and transfer system.[48] Rather the reason to have a tax system, especially an individuated tax system, is to finance the needs of the state in a fair and just manner. A printing press — or any of a number of far simpler taxing systems than what we have today — could raise the finances needed for public goods. In moving to *individuated* tax systems such as the broad-based income tax or any of its usual competitors, society must desire *individuated* justice.

On still further reflection, this individuated sense of justice must stem from a desire for some differentiation or progression in the allocation of tax burdens; from some sense that the better able or more fortunate should pay more than the less able or less fortunate.[49] "Genuinely progressive taxation is necessarily personal taxation," as Vickrey began his classic 1947 *Agenda for Progressive Taxation*.[50] We can add that the converse is also compelling: Personal taxation ought

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46. *See* RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE (1959); Lester C. Thurow, *The Income Distribution as a Pure Public Good*, 85 Q.J. ECON. 327 (1971); STEUERLE, *supra* note 9.

47. But see, e.g., analysis of optimal consumption tax theory in note 347 *infra*.

48. This is the argument of Louis Kaplow and Steven Shavell, first pressed in *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994), see also KAPLOW & SHAVELL, *supra* note 21. For partial critiques of the Kaplow-Shavell position, *see* Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003 (2001); Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules — Legal Rules, and Insurance*, 56 TAX L. REV. 157 (2003).

49. Under a flat percent tax, taxpayers with higher incomes pay more in absolute dollars, leading to a certain confusion in the understanding of progressivity. *See* Edward J. McCaffery & Jonathan Baron, *The Humpty Dumpty Blues: Disaggregation Bias in the Evaluation of Tax Systems*, 91 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 230 (2003) [hereinafter McCaffery & Baron, *Humpty Dumpty Blues*] (discussing the "metric effect"). The new understanding of tax aims for a progressive percent tax, that is, progressivity in effective tax rates.

50. WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 3 (1947). It is simply not compelling, normatively, as a matter of first-best theory, to impose progressive taxes on entities, where the ultimate incidence of the tax burden is apt to be uncertain, at best, and quite possibly regressive relative to individuals, at worst. *See infra* Part VI.C. *But cf.* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004) (arguing that corporate income tax is important as a check on managerial power).

to be progressive, or at least somehow individuated, based on ability to pay or benefits received or some such principle. In this regard it is worth noting that no major policy proposal in the United States at least has been for a genuinely flat tax — all so-called flat taxes feature "zero brackets," or other accommodations for family size, and so on.[51] Indeed, a persuasive case can be made out under both liberal egalitarian political theories, such as those of John Rawls, and utilitarian or welfarist conceptions of justice that, at least given fair and efficient markets, the tax system is the best or even the only place to redistribute material resources (or, perhaps better put, to set the fair initial distribution of such resources).[52]

Thus all roads lead to some individuation in tax, which means some progression.[53] This is a compelling end for tax. But questions follow: On what grounds should we determine each individual's fair share of the tax burden? In the classic language of tax policy, we look to levy taxes on individuals based on the benefits they receive from the state, their ability to pay, or both.[54] We can, with Adam Smith, elide the two principles and finesse the semantics. But in any event, the new understanding of tax turns on the insight that this question of *what* to tax is vitally connected to the question of *when* to tax. Having accepted progressivity as an end, we should ask when, in an

51. MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 51-53. Note also that progressivity can come from the expenditure side of fiscal policy. *See* Richard M. Bird & Eric M. Zolt, *Redistribution via Taxation: The Limited Role of Personal Income Tax in Developing Countries*, UCLA L. REV. (forthcoming Aug. 2005); Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution*, UCLA L. REV. (forthcoming Aug. 2005).

52. *See* JOHN RAWLS, A THEORY OF JUSTICE 278 (1971); Kaplow & Shavell, *supra* note 48; KAPLOW & SHAVELL, *supra* note 21. For a good statement of the argument that the tax system is actually helping to set an appropriate *initial* normative baseline for ownership or command over material resources, see MURPHY & NAGEL, *supra* note 6.

53. STEUERLE, *supra* note 9, at 11, writes that "[A]ny general attack on the progressivity principle, in my view, is almost tantamount to an attack on natural law theory."

54. Adam Smith famously combined the two, reasoning that those who have more ability to pay are, on that account, more benefited by the very existence of the state: "The subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 777 (Edwin Cannan ed., The Modern Library 1937) (1776). The first clause points to "ability to pay." The second clause conflates this with the benefits-received view, by implying that the revenue enjoyed "under the protection of the state" is precisely the measure of one's ability to pay. One has the ability to pay, in other words, precisely because one benefits from the very existence and structure of society, a point that echoes Amartya Sen's argument that all "individual" wealth is in fact a joint product of self and society. *See* AMARTYA KUMNAR SEN, ON ETHICS & ECONOMICS 28 (1987); *see also* AMARTYA SEN, INEQUALITY REEXAMINED (1992); STEUERLE, *supra* note 9, at 14, 31 n.11 (discussing SMITH, *supra*, at 777).

However we come out on the semantics, note that both "ability to pay" and "benefits received" are, in traditional tax policy terms, largely vertical equity norms: those with more ability, and/or those who benefit more from the state, ought to pay more. MUSGRAVE, *supra* note 46; MURPHY & NAGEL, *supra* note 6.

individual's flow of funds, is it fair and appropriate to levy progressive tax rates? In other words, when should we make the social judgments necessary to and inherent in a system of individuated progressive taxation?

In short, progressivity in tax burdens is an end, whereas any particular tax system for achieving progressivity is a means. Our commitment to the income tax is not foundational. It depends on the tax as being the best means to the ends we hold. We ought to reverse the intellectual process, to ask what tax is the best means to the end of fairness and justice.

B. *The Traditional Logic of Tax*

The political and intellectual history of tax have both influenced and, in turn, been influenced by, the way we have come to think about tax policy. This bidirectionality in reasoning helps to explain how the traditional view of tax arose and why it persists.[55] This section takes a look at the usual way of thinking about tax, in a historical context.

Who? What? When? How much? are the questions that lie at the foundation of all practical tax systems. Each must be answered sooner or later, actively or by default, to get a tax system in place. How we answer these questions — and, further, in what order we answer them — matters a great deal. The new understanding of tax changes the order of the questions.

It is logical enough to begin with the *what* question: the appropriate tax base. Whether we use ability to pay, benefits received, or both, we want to know on what basis to levy our social judgment. Hence, much of the intellectual history of tax has been consumed with asking just this question.[56] This has meant, when it comes to broad-based, comprehensive tax systems, the celebrated income-versus-consumption debate at the core of the traditional understanding of tax. There are important roots of this debate in the writings of Hobbes and Smith, both of whom came down on the side of consumption taxes, for rather different reasons.[57] Then came Mill and his analytic

55. For a general discussion of bidirectionality in legal reasoning, see Dan Simon, *A Third View of the Black Box: Cognitive Coherence in Legal Decision Making*, 71 U. CHI. L. REV. 511 (2004).

56. *See, e.g.*, BABETTE B. BARTON ET AL., TAXATION OF INCOME 1992-1993, at 4 (1992); BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 2.1 (2d ed. 1995); MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION (9th ed. 2002); KLEIN ET AL., *supra* note 40, at 7; JOHN K. MCNULTY & DANIEL J. LATHROPE, FEDERAL INCOME TAXATION OF INDIVIDUALS 31 (1999).

57. *See* THOMAS HOBBES, LEVIATHAN 386-87 (C. B. MacPherson ed., Pelican Books 1968) (1651).

> [T]he equality of imposition, consisteth rather in the equality of that which is consumed than of the riches of the persons that consume the same. For what reason is there that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more

critique of the income tax as a double tax on savings, and the seemingly concomitant argument for a proportionate consumption tax. This argument has been enormously influential within the domain of political theory proper: Rawls has accepted the argument for consumption taxation (indeed, proportionate consumption taxation), at least in ideal theory, citing to Nicholas Kaldor,[58] and the "ultra liberal" thinker Roberto Unger has also recently endorsed consumption taxation as well.[59]

Practical politics, however, have come down decisively on the other side of the great divide. Having experimented with income taxation in the nineteenth century, America made a firm commitment by ratifying the Sixteenth Amendment in 1913 and implementing a statute within months, all motivated, at least in large part, by a progressive desire to get at the fruits of capital.[60] Policymakers at the time rejected a wide range of consumption tax alternatives, in part because of the fact that consumption typically forms a higher percent of disposable income for the lower- and middle-income classes than it does for the upper-income class — in other words, because the rich save more.[61] This led to a "base argument" for income taxation,[62]

> charged than he that living idlely, getteth little, and spendeth all he gets, seeing the one hath no more protection from the commonwealth than the other? But when the impositions are laid upon those things which men consume, every man payeth equally for what he useth, nor is the commonwealth defrauded by the luxurious waste of private men.

Id. Fried, *supra* note 7, at 962; Warren, *supra* note 13, at 933-34. SMITH, *supra* note 54, at 778.

> Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. . . . Taxes upon such consumable goods as are articles of luxury, are all finally paid by the consumer, and generally in a manner that is very convenient for him. He pays them little by little, as he has occasion to buy the goods. As he is at liberty too, either to buy, or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniency from such taxes.

Id.

58. RAWLS, *supra* note 52, at 278, noting the common pool argument. Rawls was quick to add that, in practice, "even steeply progressive income taxes" may be the right answer, and here he joined with his fellow practical political liberals. *Id*. at 279. *See also* NICHOLAS KALDOR, AN EXPENDITURE TAX (1955); Kaldor begins his volume with the quotation from HOBBES, in note 57, *supra*. *See also* Mill, *supra* note 1.

59. *See* ROBERTO MANGABEIRA UNGER, DEMOCRACY REALIZED: THE PROGRESSIVE ALTERNATIVE 51-52 (1998).

60. *See* Jensen, *supra* note 4, at 1093-131. Of course, these arguments against a consumption tax are based on the traditional view of tax.

61. *See* POLLACK, *supra* note 4; STANLEY, *supra* note 4; Bank, *supra* note 4; Jensen, *supra* note 4; Slemrod, *supra* note 12. The equivalence of the formulations follows from the Haig-Simons "definition," or identity, discussed below, that holds, in short, that *Income = Consumption + Savings*. *See infra* Part II.B. The variable *Savings* is, in other words, nonconsumption; if a person consumes more, she saves less, if a person saves more, she consumes less, all as a percent of income, or available resources. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 14-15.

62. *See* McCaffery, *Three Views*, *supra* note 19.

which predominated early on in the public political thinking about tax, and lingers to this day. The income base seems to be a means to the ends of tax justice.

The *how much* question has been a distant second — in terms of quantities of ink expended — to the *what* question, although much important recent work has been done on point. The reasons for the historical neglect are not hard to come by: significantly high tax rates are a distinctly modern creature, not present until the twentieth century and not widespread until the latter half of that century. Smith and Mill discussed taxes in the range of 5 to 10 percent.[63] The initial "progressive" income tax of 1913 had featured a top marginal rate, including a surcharge, of 7 percent, and it had applied to far less than 5 percent of all adult Americans.[64] It was thus the very existence of an income tax — supplemented by a corporate income tax and, later, in 1916, by an estate tax — with its deliberate inclusion of dividends and interest, that furthered the progressive cause, providing the means to the end.

Things changed.

World War I radically altered the rate schedule, ratcheting it up, and World War II transformed the breadth of the tax's application, expanding it enormously once the practical expedient of wage withholding was discovered.[65] The top marginal rate bracket under the income tax rose to above 90 percent during World War II, and stayed at 90 percent throughout the 1950s, until John F. Kennedy cut it — to 70 percent — in 1963. These high tax rates now added to the base as means to the ends of justice in tax. But, meantime, the dramatic expansions in scale and scope triggered the perceived need for some previously scarce thought, reflection, and justification: Why did we have such steep progressivity in tax rates?

Walter Blum and Harry Kalven, writing in full view of extremely high nominal rates, set the tone for postwar scholarship by sounding a skeptical note, sketching out the "uneasy case" for progressivity.[66] Later, the case was made to seem far less uneasy by the economic analysis of optimum income taxation most famously made out by the Nobel Laureate James Mirrlees, and subsequently brought into a wide tax scholarly readership by Joseph Bankman and Thomas Griffith — the latter pair writing after Ronald Reagan, America's second great

63. SMITH, *supra* note 54, at 777, 782; Mill, *supra* note 1, at 171-73.

64. W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA 44-46 (1996); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 78 (1985).

65. BROWNLEE, *supra* note 64; POLLACK, *supra* note 4; Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685, 686, 697 (1988/89).

66. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

income-tax-cutting President, had slashed the top marginal rate all the way down to 28 percent.[67] Mirrlees, Bankman and Griffith, and the wider welfarist or utilitarian turn in law-and-economics theory lent a strong hand to the arguments for progressivity in tax. Given any form of diminishing marginal utility of wealth, social welfare could improve, under specified conditions, by taking proportionately more from those who have proportionately more material resources.[68] Further, the theory of optimal income tax gave prescriptive advice for how to effectuate progressivity in tax, without relying excessively — and perhaps counterproductively — on steep marginal tax rates.[69] Such rates are only a means to the end of redistribution.[70] The optimal income tax movement attempted to reground analysis of the tax rate structure in the compelling framework of ends, equity and efficiency.

What is most important at this stage of the story is that the rate questions historically followed the base ones. Because high rates and a broadened base arose in the shadows of the actual income tax, which itself had followed from a simple conception of the income-versus-consumption debate, the traditional view of tax infused the understanding of the effects of tax rates. Since it was by now assumed that a consumption tax base was more inherently regressive than an income tax base — the base argument — a "rate argument" seemed to follow naturally enough.[71] If consumption taxes are regressive, a progressive consumption tax must be doubly so. More sophisticated scholars fell into a subtler trap. If the *reason* for a consumption tax was to exempt the yield to capital, as the traditional conception of the income-versus-consumption debate would have it be, then the rate structure of any consumption tax was constrained. And so a rate argument joined with the base argument to favor an income tax in the service of progressivity or liberal egalitarianism.

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67. *See* Mirrlees, *supra* note 12; Bankman & Griffith, *Social Welfare*, *supra* note 12; *see also* Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465 (1987). *See also* VICKREY, *supra* note 50. Mirrlees and Vickrey won the 1996 Nobel Prize in Economic Sciences in large part for their work on tax. See Press Release, The Royal Swedish Academy of Sciences, The Sveriges Riksbank (Bank of Sweden) Prize in Economic Sciences in Memory of Alfred Nobel for 1996 (Oct. 8, 1996) at http:www.se/economics/laureates/1996/press.html (noting their contributions to optimal taxation theory).

68. KAPLOW & SHAVELL, *supra* note 21; Bankman & Griffith, *Social Welfare*, *supra* note 12.

69. *See* Bankman & Griffith, *Social Welfare*, *supra* note 12; Berliant & Rothstein, *supra* note 12; Mirrlees, *supra* note 12. The important distinction between marginal and average, or (equivalently) effective, tax rates shall factor into the new understanding of tax. A flat percent tax combined with a lump sum tax effectuates progressivity in average, or effective, tax rates. See MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 79-85, for a simple illustration.

70. *See* Mirrlees, *supra* note 12. Part of Mirrlees's brilliance was to show convincingly how progressivity in effective rates could be obtained without progressivity in marginal ones.

71. *See* McCaffery, *Three Views*, *supra* note 19.

The *what* and *how much* questions, asked in that order, have dominated discussions of tax policy, inside and outside the academy. The relative neglect of the *who* question has been unfortunate, for deep issues of justice lie buried in both the seemingly arcane questions of attribution, that is, of the appropriate taxable unit, and of the equally arcane questions of incidence, that is, of who really, ultimately, bears the burden of various alternative taxes.[72] If the central aim of tax as an instrument of social justice is to get citizens to share in the burdens of their society in proportion to something — their ability to pay, their benefits received, or some combination thereof — it matters critically who is in fact bearing the burden of any particular tax.

This then leaves the *when* question. It is hardly the case that matters of time and tax have been understudied.[73] But the questions of time have been framed by the seemingly prior and foundational *what*, or tax base, question. There have been two large and persistent themes.

First, principles of timing have been used to help inform the fundamental tax base debate, that is, to illustrate the difference between income and consumption taxes. Under the traditional view, timing principles have been used to show the equivalence of prepaid and postpaid consumption taxes in present value terms, and the differences between an income and any consumption tax.[74] There are only differences over time, after all — savings, which is analytically identical to nonconsumption, only exists in what an economist would call a "two period model."[75] The initial mapping between an income tax as a double tax on savings, on the one hand, and both forms of consumption tax as involving no effective taxation of the yield to savings, on the other, was made out in simple, partial-equilibrium models. Since then, more sophisticated financial analysis has suggested that some but not all of the yield to capital is taxed under a postpaid, but not a prepaid, consumption tax — the "supranormal" or

72. EDWARD J. MCCAFFERY, TAXING WOMEN (1997) [hereinafter MCCAFFERY, TAXING WOMEN]; Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49 (1972); Edward J. McCaffery, *Equality, of the Right Sort*, 6 UCLA WOMEN'S L.J. 289 (1996).

73. *See*, *e.g.*, Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967). *See generally* Cunningham, *supra* note 7; Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH L. REV. 722 (1990); Kelman, *supra* note 8; Klein, *supra* note 14; Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243 (1992); Strnad, *Periodicity and Accretion Taxation*, *supra* note 37.

74. *See supra* note 7 and accompanying text.

75. *See* Strnad, *Taxing Convertible Debt*, 56 SMU L. REV. 399, 448 (2003); *see also* Jeff Strnad, *Periodicity and Accretion Taxation*, *supra* note 37.

"inframarginal" returns, in some specifications, the return to risk, in others.[76]

Second, principles of timing have been brought into play in the context of what is wrong with the "income" tax: how its failure to currently tax all of the yield to capital leaves it short of its animating ideal, and how to cure this defect.[77] Tax policy scholars have analyzed how and when to tax capital appreciation — or "ordinary" appreciation masquerading as "capital" appreciation — so as to effectuate a practicable income tax. Some scholars, for example, have considered a form of "taxation on realization," or "retrospective capital gains," to make up for the deferral of taxes created by an

76. Much recent tax policy literature has been breaking down the analytics of the return to capital and exploring the related empirical and macroeconomic issues. Scholars have analyzed the different components of the yield to capital — compensation for risk or inflation, inframarginal returns, the pure riskless rate of return — with the income-versus-consumption debate in mind, showing how different tax systems, with and without certain technical features (such as full loss offsets under an income tax), affect each component. *See* sources cited in note 39, *supra*.

This is all interesting and important work. A central message of this descriptive, analytic traditional literature is that a postpaid consumption tax, even with constant tax rates, most likely captures some or all of the supranormal returns to capital, whereas a prepaid consumption tax, by design, captures none of it. The traditional view has often left it at that; with Andrews's "most sophisticated" argument haunting the consumption tax, the facts of the matter might even suggest a prepaid consumption tax from this analysis. Within the new understanding of tax, in contrast, where the commitment to progressivity comes first, the possibility that even a constant-rate postpaid consumption tax gets at some of the extraordinary returns to capital offers yet another reason to prefer the postpaid model over the prepaid, yield-exempt one. The analytics normatively suggest a prepaid model only if (1) the reason for adopting a consumption tax is to preserve the pretax equality of present and deferred consumers (Mill's insight and Andrews's most sophisticated argument, again), and (2) the proper moment for deciding on that equality is ex ante to the distribution of returns from the capital market. If these two conditions held, it would be "wrong" — nonneutral — to burden any of the windfall return with a "second" tax. But both prongs are normatively dubious at best. The horizontal equities of Ant and Grasshopper are not the best reasons for adopting a consumption tax, and an ex post perspective more befits a social concern with individuated justice, given the moral arbitrariness of varying returns to capital, and, within the new understanding of tax, the wisdom of waiting until ultimate private preclusive use to make judgments about the yield to capital. This latter point, which echoes a strong theme of Warren's — namely, that tax policy should take an ex post perspective — is, in essence, the yield-to-capital norm. Warren, *supra* note 13; s*ee also* Gentry & Hubbard, *Distributional Implications*, *supra* note 11; William M. Gentry & R. Glenn Hubbard, *Fundamental Tax Reform and Corporate Financial Policy*, 12 TAX POL'Y & ECON. 191, 196-97 (1998) (citing U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992)); Barbara H. Fried, *Ex Ante/Ex Post*, 13 J. CONTEMP. LEGAL ISSUES 123 (2003).

77. *See* Fellows, *supra* note 73; Halperin, *supra* note 73; Shakow, *supra* note 73; David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 TAX L. REV. 499 (2000); Jeff Strnad, *Periodicity and Accretion Taxation*, *supra* note 37. *See generally* Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355 (2004); Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503 (2004); David M. Hasen, *A Realization-based Approach to the Taxation of Financial Instruments*, 57 TAX L. REV. 397 (2004).

income-with-realization-requirement tax;[78] others have explored questions of "original issue discount" and similar mechanisms for disguising the ordinary return to savings as capital appreciation.[79] All these technical questions have been framed by the income-versus-consumption debate: they arise out of an attempt to ensure that the "income" tax is, in fact, an income tax.

These timing matters are important questions, to be sure. The tax-policy literature has generated valuable insights into matters of tax-policy design by asking them. But they are not the central questions of the fair timing of tax. A different question waits to be asked, one that promises new and pressingly practical insights into matters of tax-policy design. Asking it lies at the core of the new understanding of tax. The new timing question sounds in a commonsensical morality, and follows from the first commitment of the tax system, to having at least moderately progressive rates:

> When, in a taxpayer's flow of funds, is it fair and appropriate to levy progressive taxes?

This is an altogether different question from traditional ones of timing, and the answers it leads to — the ways it leads us to think about tax — are fundamentally different as well. The new understanding of tax follows a different logic than the traditional view. It begins with a commitment to progressivity and moves out to questions of timing. I explore this later. But first let us dwell a bit longer in the intellectual history of tax, to better understand where we are, and how we got here.

C. *The Modern Income-Versus-Consumption Debate*

The contemporary origins of the income versus consumption tax debate, which has raged for centuries, lie in the works of two Harvard law professors, William Andrews and Alvin Warren, beginning in the 1970s. This debate repays a close and careful visit.

1. *The Case for Consumption*

The Haig-Simons definition ($I = C + S$), and its manipulation to show the essential structure of a consumption tax ($C = I - S$), was central to two important articles by Andrews, each published in the

78. *See*, *e.g.*, Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991); Alan J. Auerbach, Commentary, 48 TAX L. REV. 529 (1993); Fellows, *supra* note 73; Shakow, *supra* note 73; Shakow & Shuldiner, *supra* note 77; Strnad, *Periodicity and Accretion Taxation*, *supra* note 37.

79. *See*, *e.g.*, Halperin, *supra* note 73.

Harvard Law Review in the early 1970s. In the first, published in 1972, Andrews used the relationship to suggest that while source neutrality, or the idea that the type of inflow should not matter to judgments about tax, was a compelling norm, use neutrality was far less obviously so.[80] Features of the "income" tax, such as deductions for extraordinary medical expenses[81] or charitable contributions,[82] could be understood as appropriate normative refinements of the right-hand side of the Haig-Simons identity. In other words, not all "consumption" *ought* to count equally, at least in accordance with well-settled practices in tax. This is an important insight, and one that should be extended to differentiating between the uses of savings as well as the uses of consumption:[83] that is a principal aim of this Article and the new understanding of tax.

Andrews's second article, published in 1974, profoundly changed the course of tax scholarship and policy.[84] Again looking to the right-hand side of the Haig-Simons definition, Andrews generalized an important real-world observation: what we call an "income tax" does a very poor job of getting at savings or, in Simons' words, "the change in value of the store of property rights between the beginning and end of the period in question."[85] Andrews argued that we ought to systematically give up the attempt to tax the yield to capital, subtracting savings from income to generate a postpaid consumption tax, on the model of Equation [2], above.

Andrews's article rekindled the income versus consumption debate, which had its roots in Hobbes, Smith, and Mill. Andrews drew especially on Nicholas Kaldor's important and more recent work on consumption or expenditure taxation.[86] In the event, Andrews's article opened a floodgate for reconsideration of the case for adopting a consumption tax. *Blueprints for Basic Tax Reform*, an influential Treasury Department study, largely authored by the public finance economist David Bradford (who later collaborated with Andrews), sketched out two routes for tax: perfecting the nominal income tax, and adopting a progressive postpaid consumption tax, a la Andrews's 1974 article.[87] By the mid-1990s, the latter idea had ripened into a full-

80. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 331-37 (1972) [hereinafter, Andrews, *Personal Deductions*].

81. I.R.C. § 213 (2004).

82. I.R.C. § 170 (2004).

83. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2; McCaffery, *Hybrid*, *supra* note 23, at 1175-218.

84. *See* Andrews, *Personal Income Tax*, *supra* note 8.

85. SIMONS, *supra* note 29, at 50.

86. NICHOLAS KALDOR, AN EXPENDITURE TAX (1955).

87. BRADFORD, ET AL., *supra* note 8.

scale legislative proposal, the Nunn-Domenici USA (for "unlimited savings allowance") Tax, which made it to the House floor in 1995.[88]

For all its power and influence, however, the reformulated Haig-Simons definition of "consumption" taxation has led to an analytic confusion. It is true that a postpaid consumption tax does not tax the act of savings, or the use of available resources to save. But a *progressive* postpaid consumption tax can, and — this Article argues — ought to, under the appropriate circumstances, tax the yield to capital as the source of present consumption. It is all a matter of the fair timing of tax. This was an insight that Andrews himself made, in passing, in his 1975 reply to Alvin Warren's critique of his 1974 article.[89] But by then, perhaps, it was too late. As with the Haig-Simons definition, the analytics had morphed into a norm: an *is* had become an *ought*.[90]

Andrews, like Mill in the prior century, had grounded the case for consumption taxation on the principled basis that the yield to capital should not be taxed. He had chosen a postpaid as opposed to a prepaid tax model partly on the grounds of administrative concerns: *Blueprints for Basic Tax Reform*, like Andrews, was content to change over to a prepaid consumption tax model when it was more convenient to do so.[91] As Andrews put his "most sophisticated argument" for consumption taxation in his 1974 article:

> [T]he lesser burden of a deferred tax is more appropriate because it ultimately imposes a more uniform burden on consumption, whenever it may occur, than does an accretion-type tax. . . . Neutrality with respect to consumption is important not only because it promotes efficiency in the allocation of income, but because it keeps the tax from bearing more

88. USA Tax Act of 1995, S. 722, 104th Cong. (1995); *see* SEIDMAN, *supra* note 41; David Wessel, *Nunn-Domenici 'USA Tax' Puts Levy on Consumption to Encourage Saving*, WALL ST. J., Apr. 26, 1995, at A2; *see also* David Wessel, *Another Round: Talk of Tax Reform is Gaining Momentum, But Plans Vary Widely*, WALL ST. J., Jan. 31, 1995, at A1.

89. Andrews, *Reply to Professor Warren*, *supra* note 16, at 949; see Warren, *supra* note 13, for the critique, and Andrews, *Personal Income Tax*, *supra* note 8, for the original 1975 article.

90. *See* DAVID HUME, A TREATISE ON HUMAN NATURE 469-70 (L.A. Selby-Bigge ed., 2d ed. 1978) (1739) (presenting Hume's famous dictum that an *ought* cannot be derived from an *is*); Liam B. Murphy, *Liberty, Equality, Well Being: Rakowski on Wealth Transfer Taxation*, 51 TAX L. REV. 473, 473-74 & n.4 (1996) (arguing that popular opposition of the estate tax does note necessarily mean it should be replaced); Eric Rakowski, *Transferring Wealth Liberally*, 51 TAX L. REV. 419, 421-22 (1996) (same, invoking Hume).

91. BRADFORD, ET AL., *supra* note 8. Andrews protests considerably that a postpaid or cash-flow consumption tax is not equivalent to a prepaid consumption or wage tax, especially under variable rates — the insight behind the new understanding of tax. *See* Andrews, *Reply to Professor Warren*, *supra* note 16, at 953-55. But the point was not systematically developed by Andrews, by Bradford in *Blueprints for Basic Tax Reform*, or by later writers in the tradition.

> heavily on one person than another on account of differences in need or taste for particular goods or services, now or in the future.[92]

There is no denying the sophistication of this argument, or of Andrews's elegant formulation of it. Ultimately, it is its rightness — its claims to being foundational to the argument for consumption taxation — that is in question.[93] Under the new understanding of tax, Andrews's most sophisticated argument becomes, quite simply, the wrong reason (the principled nontaxation of the yield to capital) for the right tax (the postpaid consumption tax); advancing this argument has had a harmful influence on the development of tax policy.

2. *The Income Empire Strikes Back*

There is also no denying Mill's facts of the matter. An income tax falls twice on wealth that is saved; a consumption tax falls once, as the equations set out above have shown. But there is, of course, much room to argue about the normative consequences of this analytic fact: Is Mill's second tax a good or a bad thing?

Alvin Warren answered Andrews's 1974 article arguing for a postpaid consumption tax in a tremendously influential fashion. Warren's first response was a brief comment, in 1975, later expanded in a 1980 article.[94] A major part of Warren's effort was to turn Mill on his head. Yes, an income tax imposes a second tax on savings, Warren conceded, but that was a good thing: the yield to capital was an additional increment to wealth that differentiated its recipients from those who did not get it. Andrews had made a "horizontal equity" argument in defense of the postpaid consumption tax, arguing that the "most sophisticated" argument for a consumption tax was to preserve the pretax equality of savers and spenders.[95] This argument was to get Andrews — and the case for consumption taxation generally — in significant trouble. Warren rightly pointed out that its logic led to a case for flat, or nearly flat, rates.[96] For under progressive or variable tax rates, as a descriptive, analytic matter, the equivalence of the

92. Andrews, *Personal Income Tax*, *supra* note 8, at 1167-68.

93. Actually, in its final clause, this quotation suggests the argument advanced by Vickrey, and this Article: Tax should not fall more heavily on any person on account of the morally arbitrary time path of her *earnings* pattern. *See* VICKREY, *supra* note 50. But under a progressive postpaid consumption tax, tax does fall more heavily on taxpayers with higher *tastes* for goods and services; that is the very thing being taxed, and progressively.

94. Warren, *supra* note 13; Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980).

95. *See supra* text accompanying note 92. On horizontal equity, see generally MURPHY & NAGEL, *supra* note 6, at 37-39; MUSGRAVE, *supra* note 46; STEUERLE, *supra* note 9, at 10; for criticism, see Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Kaplow, *supra* note 9; Griffith, *supra* note 9.

96. Warren, *supra* note 13, at 944-45.

prepaid and postpaid consumption tax models can be destroyed, and the yield to capital can bear some tax.

Warren responded to Andrews by primarily making a vertical equity argument to counter Andrews's horizontal equity ("most sophisticated") argument. Warren also importantly shifted the analysis from the ex ante equality of present and deferred consumers (spenders and savers, like Ant and Grasshopper) to ex post outcomes.[97] The saver has more than the spender in the *second* time period, after all; it is thus fair and appropriate to tax her more. This was an argument whose roots could be found in the writings of prominent public finance economists.[98] More important, it resonated with popular sentiment and with the very reason for the income tax in the first place. Only wealthy persons have the capital to generate any significant yield at all. The vast masses of people living from paycheck to paycheck are hard pressed to understand an argument of ex ante equality suggesting that this yield should escape tax altogether when it comes to their distant, and rich, fellow citizens. Ordinary citizens are even less likely to understand or accept arguments that the stream of value had already been taxed (as Mill would have it) or that the lingering psychic benefits of present consumption — the memory of things past — were not being taxed, so they had no real complaint vis-à-vis the savers even if the yield to capital was tax-exempt.[99] In siding with popular morality and common sense, Warren was invoking what the new understanding of tax calls the yield-to-capital norm.

Meanwhile, Andrews's argument for horizontal equity haunted the consumption tax crowd, although Andrews tried, tentatively, to back off from it in his 1975 reply to Warren's critique.[100] Warren's argument for vertical equity was more powerful than Andrews's horizontal equity defense of consumption taxation, suggesting that attitudes towards progressivity and the redistributive force of tax drive conceptions of "fairness" more than the always tricky semantic or rhetorical comparisons of putative equals.[101] The new understanding of tax involves putting the commitment to progressivity front and center: the central end of any broad-based tax is to effect some redistribution of material resources. While the case for a postpaid consumption tax has an element of horizontal equity within it, as seen by the Ant-

97. *See* Warren, *supra* note 13, at 941-44. For a discussion of ex ante versus ex post perspectives, see KAPLOW & SHAVELL, *supra* note 21, at 28-30; Fried, *Ex Ante/Ex Post*, *supra* note 76.

98. *See* IRVING FISHER & HERBERT W. FISHER, CONSTRUCTIVE INCOME TAXATION (1942); KALDOR, *supra* note 86.

99. *See* Kelman, *supra* note 8, at 659; Warren, *supra* note 13, at 936; Warren, *supra* note 94, at 1100.

100. *See* Andrews, *Reply to Professor Warren*, *supra* note 16, at 953-56.

101. *See* Griffith, *supra* note 9; Kaplow, *supra* note 9; Kaplow, *supra* note 95.

Grasshopper example, as we shall see, even that element of horizontal equity is better understood as specifying the appropriate basis of comparison for the more fundamental vertical equity judgments.

3. *Why It Matters*

In the intellectual back-and-forth over the income-versus-consumption debate, something important had been lost. Andrews had begun his 1974 article with a critique of the current "income" tax as not getting at the yield to capital at all: most of the article is concerned with a careful, critical analysis of the status quo in tax, with the claims for the "fairness" of a postpaid consumption tax more or less tacked on at the end. Warren had counterpunched with an attack on Andrews's "most sophisticated argument" — an ideal argument for a consumption tax based on the principled nontaxation of the yield to capital. This left open the intriguing possibility that Andrews was right, but for the wrong reason — he was actually right for *Warren's* reason. In practice, a consumption tax, of the right sort, is the best real-world tax precisely because it does, and the actual income tax does not, get at the yield to capital. Part V, below, extends Andrews's critique of the so-called income tax to illustrate how the tax has become a specifically prepaid consumption one. In theory, the ideal income tax "double taxes" all savings, whereas a postpaid consumption tax burdens some but not all savings, and in just the right cases —where capital and its yield are elevating lifestyles (a vertical equity norm), and not where capital and its yield are compensating for arbitrarily uneven labor market earnings (a horizontal equity norm). A consumption tax of the right sort best upholds the principles of source neutrality and vertical equity, all while making a better use of the ordinary moral intuitions about horizontal equities in comprehensive tax system design.

By resting the case for consumption tax on the preservation of the pretax equality of saver and spender —a horizontal equity argument — Mill and Andrews were inclining the tax system towards flat rates. In order to preserve this pretax equality, a postpaid consumption tax must work like a yield-exempt or prepaid one: t_1 must equal t_2 in Equation [7], above. The new understanding of tax turns on what happens when t_1 does not equal t_2, by design. At a crucial minimum, the argument structure for tax changes. Prepaid and postpaid consumption taxes are no longer automatically equivalent. Only the prepaid model features yield exemption by design. Postpaid consumption taxes sometimes burden the yield to capital, at other times do not. The case for choosing a progressive postpaid consumption tax must therefore rest on arguments different from Mill's "double tax" point or Andrews's "most sophisticated

argument," or, for that matter, arguments about the appropriate levels of individual or aggregate social savings. Indeed, they do.

The result of the intellectual history of tax has been, from a public policy point of view, unfortunate. Both canonical forms of consumption tax have been linked, viewed as broad equivalents, and tethered to both flat tax rates and the principled argument for the total nontaxation of the yield to capital. The case for consumption taxation has suffered on the altar of our prior commitment to progressivity. In the traditional view, the progressive income tax stands alone against the barbarian, nonredistributive flat consumption taxes at the gates, and doubly so: both because the income tax features progressive rates, whereas there is a (wrongheaded) tendency to pair flat rates with consumption taxes (the rate argument), and because consumption taxes are assumed to exempt all or most of the yield to capital on purpose (the base argument). This has put liberals and progressives in the intellectually and politically untenable position of defending a highly flawed, highly unpopular status quo in tax, against any and all structural reform. Yet, ironically, once we accept progressivity in the rate structure as the first commitment of a comprehensive tax system, the very equivalence of yield-exempt and postpaid consumption taxes no longer holds. Our eyes can open: the case for consumption taxation need not be about the importance of capital in the small or large at all.

A final and related point: In the grip of both the income-versus-consumption debate and Andrews's (and many others') horizontal equity argument for consumption taxation, the analysis of the yield to savings has been *source* driven. The literature at least implicitly looks to the left side of the Haig-Simons equation, Equation [1], and asks from whence a particular return to savings came. Was the return to capital merely compensation for inflation, the real riskless rate of return, compensation for risk, a windfall, or yet something else? These are questions and classifications based on the nature of the input. The new understanding of tax firmly shifts the analysis — as Andrews generally had begun to do, in both his 1972 and 1974 articles — to the *uses*, or right-hand, side of the Haig-Simons identity. A postpaid consumption tax consistently finesses questions of where, exactly, the funds for private preclusive use or (equivalently) consumption come from: it is source neutral in this important sense. What matters — and all that matters — is how the returns are used, or what level of lifestyle they finance.[102] The focus is on outputs.

102. For example, a taxpayer who engages in high-risk investments might indeed receive some high or supramarginal returns, but this same taxpayer is likely to lose on other investments so that, on balance, he or she will not "beat the market." *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (rev. ed. 1999) (relaying a popular account of the "efficient market hypothesis"). A tax system designed somehow to isolate supramarginal returns faces a practical problem. To be fair, it ought to allow loss deductions

D. *Two Political Takes*

Theory and intellectual history matter. Today's political world follows the academy's lead on the understanding of tax. Crudely, most tax politics have come down to a battle of liberals versus conservatives, with the vast moderate middle holding the all-important swing vote. Liberals support a progressive income tax. They are very much concerned with the base, or *what*, and the rate, or *how much*, parts of tax policy design, following the logic of tax set out above. A good deal of liberal energy has been exerted arguing for an income base, as well as for other taxes on wealth and capital — such as a separate wealth transfer or gift and estate tax; a corporate income tax; and, sometimes, a direct tax on wealth[103] — in order to get at capital or its yield. Liberals of various stripes have also advocated progressive rates, to further advance the cause of redistribution.

Conservatives, meanwhile, have taken to arguing for flat consumption taxes.[104] Flat consumption taxes of various types are, indeed, broadly equivalent in their economic effects: all work to exempt from taxes all or most of the yield to capital under plausible assumptions. The choice between wage taxes, sales taxes, value-added taxes, and flat "income" taxes that exempt all capital gains, interest, and dividends comes down to, in good faith, matters of administration and, in less good faith, whatever the public will buy.[105]

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as well. But loss deductions under an income-with-realization tax are problematic. *See infra* Part V. especially V.C. Even an ideal income tax, without the realization requirement and with some kind of inflation adjustment to isolate out high investment returns, faces a temporal problem under progressive rates: What if the supranormal high and low returns occur in different taxable periods? These problems are all solvable, of course, in theory (see, for example, former law I.R.C. §§ 1301-05 (repealed 1986) (on income averaging); William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 LAW & CONTEMP. PROBS. 736 (1969); discussion in Part IV.E, *infra*), but at the price of considerable real-world complexity. Meanwhile, a postpaid consumption tax gets this all right, as a matter of design. Since the tax only falls on actual expenditures, and since such expenditures, across a lifetime, can only be financed by net capital market returns (as well as labor market returns and beneficent transfers), the net yield to capital as used to finance consumption will be taxed.

103. *See, e.g.*, BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY (1999); Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990); Joseph Bankman, *Commentary: What Can We Say About a Wealth Tax?*, 53 TAX L. REV. 477 (2000); Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983); Rakowski, *supra* note 15; Daniel N. Shaviro, *Commentary: Inequality, Wealth, and Endowment*, 53 TAX L. REV. 397 (2000).

104. *See, e.g.*, ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995); Robert E. Hall & Alvin Rabushka, *Putting the Flat Tax into Action*, *in* FAIRNESS AND EFFICIENCY IN THE FLAT TAX 3 (1996). Grover Norquist, President of Americans for Tax Reform, and Stephen Moore, President of the Club for Growth, notably, have spearheaded the current conservative efforts. *See*, *e.g.*, Stephen Moore, Editorial, *How Much Tax Would You Like to Pay?*, WALL ST. J., Jan. 27, 2005, at A12.

105. *See, e.g.*, SLEMROD & BAKIJA, *supra* note 7, at 14-15; David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 599 (2000).

An important practical fact of the matter is that conservatives — after scoring important victories in the 1980s, under Ronald Reagan, to bring progressive marginal rates down — rather decisively lost the battle to go all the way to a flat-rate system, in both politics and the academy.[106] While several candidates for the Republican presidential nomination, most prominently Steve Forbes and Jack Kemp, have championed the idea, none have been able to translate its initial popularity into any enduring appeal. Indeed, Kemp had to back off from the idea when he became a vice-presidential candidate under Bob Dole, who, like George W. Bush, was to advocate an across-the-board rate cut on income taxes that would lessen, but significantly not eliminate, progressivity in the tax. Later, when then President George W. Bush created a bipartisan panel to study tax reform and present a report of policy options to the Secretary of the Treasury, he included among several charges that the panel proffer only plans that offered to tax in "an appropriately progressive manner."[107] Meanwhile, inside the academy, critics of "flat" have scored decisive intellectual victories, virtually unopposed by reasoned argument on the other side.[108] The idea of progressivity in tax burdens would appear to be here to stay.

Still, this popular center may not hold. Incremental reform within the so-called income tax, by moving the tax system towards a prepaid consumption tax model, has also been flattening tax rates, and tying the hands of future generations that might want to restore more meaningful rate progression.[109]

How can this be — that progressivity is desired and disappearing at one and the same time? The answer to the apparent paradox lies in the choice of tax base. Although the base and rate structures are logically, analytically distinct matters,[110] they are, of course, politically

106. *See* Edward J. McCaffery, *The Missing Links in Tax Reform*, 2 CHAP. L. REV. 233 (1999); Weisbach, *supra* note 105; Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 2 CHAP. L. REV. 197 (1999); Clay Chandler, *Taking a Democratic Cue, GOP Rivals Declare 'Class War' on Forbes*, WASH. POST, Feb. 2, 1996, at A12; John Harwood, *Forbes Plans to Drop Out of GOP Presidential Race*, WALL ST. J., Mar. 14, 1996, at A20; Jacob M. Schlesinger, *Party Favors: Why Tax Reform Won't Top the Agenda of the Next President*, WALL ST. J., Oct. 26, 2000, at A1; Lester, *supra* note 21 (poll results indicating popular opposition to flat tax).

107. At least one of the plans had to include an income tax base. Exec. Order No. 13369, 70 Fed. Reg. 2323 (Jan. 7, 2005).

108. *See, e.g.*, Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157 (1999); *The State of Federal Income Taxation Symposium: Rates, Progressivity, and Budget Processes*, 45 B.C. L. REV. 989 (2004).

109. *See* Grover Norquist, *Step-By-Step Tax Reform*, WASH. POST, June 9, 2003, at A21; Bruce Bartlett, *Bush's High Five*, NAT'L REV. ONLINE, Feb. 10, 2003, *available at* http://www.nationalreview.com/nrof.bartlett/bartlett021003.asp ("By Bush's second term, it is possible that we will have made enough incremental progress toward a flat rate consumption tax that we may finally see fundamental tax reform fully enacted into law. If so, it will be a testament to a very clever, yet bold strategy that was initially invisible. . . .").

110. Zelenak, *supra* note 39; McCAFFERY, FAIR NOT FLAT, *supra* note 2, at 11.

and economically connected. This is so, not simply in the sense that Stanley Surrey was fond of pointing out, namely, that any shrinkage to the tax base, *ceteris paribus*, has to lead to an increase in tax rates.[111] On a deeper, more fundamental level — at the stage of initial tax system design — the nature of the tax base shapes and constrains the practical political possibilities for progression in the rate structure. Taxes on wages are especially constrained because high tax rates, especially high marginal tax rates, deter the socially important and morally unobjectionable activity of working. In the new understanding of tax — contrary to the traditional opposition of income and consumption taxes — income and prepaid consumption taxes stand on one side of a divide, as taxes on inflows, which means, principally, taxing labor market earnings.[112] Postpaid consumption taxes stand on the other side of the divide, as taxes on outflows. It is far easier, and better, in both theory and in practice, to predicate progressivity on outflows rather than on inflows. High marginal tax rates on spending deter only high-end spending, but this pattern of disincentives can be good for a liberal society.[113] Today, the principal challenge to progressivity comes not from the movement away from the income tax — which, as we shall see, has been too long in coming to question seriously now, even if one wanted to — but rather from the movement to the wrong kind of consumption tax base. Conservatives have shifted their attention to this critical battlefield, and are diligently working to create a prepaid — and, not coincidentally, a relatively flat — consumption tax.

Liberals, for their part, have failed to think through the ramifications of their victory on the *how much* front. They continue to fight for an income tax and its traditional adjutants, the gift and estate, and corporate income taxes. In all this, liberals have been ill-served by the traditional understanding of tax. It turns out that there is more than one way to skin the capitalist cat. In theory, given progressive

111. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM (1973); STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985); Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental* Assistance, 84 HARV. L. REV. 352 (1970); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); *see also* Boris I. Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968); Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

112. A prepaid consumption tax only taxes labor earnings, by design. An ideal income tax is designed to tax the yield to capital as well, but, in practice, it reaches capital income to a far lesser extent than it does labor market earnings. The failure of the so-called income tax to reach much of the yield to capital effectively makes it a wage tax.

113. *See* ROBERT H. FRANK, LUXURY FEVER 232-35 (1999); McCaffery, *The Right to Waste?*, *supra* note 24; at 87-91 *see also infra* note 347 (discussing optimum consumption tax theory).

rates, an income tax, per se, is no longer needed to get at the yield to capital. Further, in practice, the actual income tax is not even good at doing the very thing that liberals insist on retaining it to do — namely, getting at the yield to capital — and it is highly unlikely ever to improve in that regard. There are deep, structural reasons for this failure, sounding not just, or even primarily, in practical or administrative concerns — though these are profound — but far more so in normative reasons. To wit, most liberals do not want to perfect the income tax, for they do not want to get at the yield to capital in all instances: tax-favored savings plans have been as much, if not more, a feature of Democratic, rather than Republican, tax policy for many decades.[114] Advocates of redistributive taxes must wake up and realize that their end is in jeopardy on account of their poor choice of means: they are fighting, and losing, the wrong war.

E. *Three Neutralities*

The three forms of taxation — income, prepaid and postpaid consumption taxes — do not map up as traditional tax theory would have them do under progressive tax rates. Each tax is unique. Each tax corresponds with a particular instantiation of a "neutrality" norm, and it is worth considering these norms. First, however, we need to ask why we should care about neutrality at all.

1. *Why Even Care About Neutrality?*

Neutrality — of the right sort — is an attractive feature of tax-law design. Neutrality is an important element of fairness to political philosophers such as Rawls, even though all thoughtful theorists are now aware that social institutions inevitably have disparate impacts on differing conceptions of the good.[115] Rawls reconciled this apparent dilemma by insisting, with others, on "justificatory neutrality" — the idea that social institutions must be justified by appeal to reasons not sounding in the advancement of any particular comprehensive

114. See Jonathan Weisman, *Democrats Put Tax Proposals in Context of Systematic Change*, WASH. POST, Jan. 12, 2004, at A5; Rob Wells, *Bush Tax Panel's Breaux Seeks Income-Consumption Hybrid*, WALL ST. J., Feb. 17, 2005, at A2 (discussing the support of John Breaux, Vice-Chairman of President Bush's Advisory Panel on Tax Reform and former Democratic Senator from Louisiana, for a hybrid-based tax).

115. *See* John Rawls, *The Priority of Right and Ideas of the Good*, 17 PHIL. & PUB. AFF. 251, 262 (1988); *see also* Thomas C. Grey, *Holmes and Legal Pragmatism*, 41 STAN. L. REV. 787 (1989); Kelman, *supra* note 8; Richard Rorty, *The Banality of Pragmatism and the Poetry of Justice*, 63 S. CAL. L. REV. 1811 (1990); Richard Rorty, *Pragmatism and Law: A Response to David Luban*, 18 CARDOZO L. REV. 75 (1996).

doctrine.[116] Neutrality, in such a sense, is a constitutive element of the fairness and legitimacy of state action.

Tax policy typically invokes neutrality in a specifically economic sense. Economic efficiency is obtained when tax systems are neutral relative to a hypothetical no-tax world.[117] This means that taxes do not distort the relative prices that emerge from such a no-tax state; it is those prices that operate to make for a competitive general equilibrium achieving first-best, Pareto-optimal, aggregate social welfare.[118] As long as any tax equally impacts all pretax prices, there is no relative change in prices, and hence no distortion in the allocation of resources, which is the exclusive concern of economic efficiency.

An attempt to obtain neutrality in this sense is suggested by Andrews's "most sophisticated" argument for consumption taxation, for the preservation of the pretax equality of savers and spenders. A consumption tax of any form — under the critical assumptions that the tax rate, t, and the rate of return, r, remain constant — preserves the pretax equality of future and present values, and hence is "neutral" in regard to the decision to save or spend. The income tax double taxes savings and thus hurts savers vis-à-vis spenders, both within the income tax regime and relative to a hypothetical no-tax world.

This is true so far as it goes. But there are serious challenges in moving from the *is* generated from these analytic facts to any compelling *ought*. One such challenge derives from the simple economic fact that all real-world taxes have distorting effects.[119] Avoiding a distortion to the saving-spending decision runs the risk of skewing the work-leisure tradeoff, for example, as Warren and others pointed out in response to Andrews. Any move from an ideal income tax to an ideal consumption tax would require raising tax rates to keep revenues constant, on account of the principled omission of an element of the tax base, the yield to capital, increasing the tax's distortions.[120] Tax, because of its incentive effects and the limited

116. *See* Rawls, *supra* note 115; *see also* RONALD DWORKIN, FREEDOM'S LAW 38 (1996); CHARLES E. LARMORE, PATTERNS OF MORAL COMPLEXITY 40-68 (1987); Bruce A. Ackerman, *What is Neutral About Neutrality?*, 93 ETHICS 372 (1983).

117. *See* FULLERTON & HENDERSON, *supra* note 33; FULLERTON & ROGERS, *supra* note 33.

118. This was proven many years ago by the seminal work of Kenneth Arrow and Gerald Debreau. Kenneth Arrow & Gerard Debreu, *Existence of a Competitive Equilibrium for a Competitive Economy*, 22 ECONOMETRICA 205 (1954).

119. Slemrod, *supra* note 12, at 157, 159.

120. This, however, is not to say that a move from the actual income tax to a consistent consumption tax would work this way; the current tax is not an ideal income tax or anything too close to it. Adopting a consistent postpaid consumption tax would have very important base-broadening features, including the inclusion of debt-financed consumption, and the elimination of preferential capital gains rates and the "stepped-up" basis for assets transferred on death. Tax rates might well decrease in any conversion to a consistent postpaid consumption tax.

information of government policymakers — not to mention administrative concerns[121] — is in a deeply "second-best" situation. There is simply no a priori way to say that welfare would improve, *ceteris paribus*, by moving from an ideal income tax to a consumption tax.

What to do? The general problem of maximizing social welfare or economic efficiency in tax is best solved by the highly intricate, sometimes counterintuitive, optimal tax literature, begun by Frank Ramsey in 1927 and importantly extended to income taxation by the Nobel Laureate James Mirrlees in 1971.[122] This literature — and this literature alone — points the way towards a thoroughly welfarist conception of tax. Under such a conception, the question of the appropriate timing of tax — as of the appropriate tax base, the appropriate rate structure, and so on — is a technical one for the experts. There is no a priori reason to favor the neutrality of any one tax over the neutrality of another, on economic grounds.

But adding to the difficulties with Mill's and Andrews's particular "neutral" argument for a consumption tax, and complicating the economics-based first objection, neutrality, as a construct of fairness, is a different matter from the narrowly economic welfarist perspective. There are two large reasons for this. First, judgments of fairness need not take the pretax status quo as normatively appropriate, although the standard economics or welfarist account, with its Paretian constraint, typically (though not universally or necessarily) does.[123] Second, and more important, the "optimal" welfare-maximizing tax answer may clash with ordinary moral intuitions and reflective normative commitments. A quick example helps to illustrate this latter point. The core insight of the Ramsey optimal tax literature is the "inverse elasticity" rule. The government should tax goods in inverse proportion to their price-elasticities. The economic intuition for the rule is straightforward: The demand for goods that are inelastically desired is less distorted by a tax, and hence pretax prices are less affected by that tax.[124] In terms of "neutrality," Ramsey taxation aims for equal and minimal distortion in the pretax, competitive general-equilibrium allocation of resources. Applying the Ramsey rule to the case of income or labor taxes, as Mirrlees did in 1971, the principle becomes that we should tax inelastic suppliers of labor more than elastic ones. This is one among several reasons to consider more tax

121. Slemrod, *supra* note 12.

122. F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927); Mirrlees, *supra* note 12. *See also* VICKREY, *supra* note 50.

123. This is a central theme of THE MYTH OF OWNERSHIP. MURPHY & NAGEL, *supra* note 6, at 31-37.

124. MCCAFFERY, TAXING WOMEN, *supra* note 72, at 170-73.

breaks for working married women, who tend to be more elastic suppliers of paid-market labor, than their husbands.[125] But such is a case where the precepts of fairness and efficiency happen to converge (making it all the more puzzling that real-world tax policy has gone in the opposite direction).[126] Convergence will not always be obtained so felicitously, however, so that we cannot avoid a more finely tuned moral reasoning in tax — we cannot turn the tax system over to a computer responding to elasticity data alone.[127] The theory of optimal income tax suggests, for example, isolating persons with especially high work ethics, such as recent immigrants or, perhaps, members of certain cultural groups placing a high value on work. Ordinary moral intuition — supported by liberal and social-contractarian political theory — should revile the thought.

The analysis shows that "neutrality" is not itself a trump, but rather a claim to be investigated empirically, and a call, but not necessarily a decisive call, on our reflective normative judgments. With these thoughts as background, another large and disturbing feature of the landscape emerges: all comprehensive tax systems have a claim to "neutrality" of some sort. Any consistently applied tax system is neutral in regards to its intended base. A tax on apples, after all, would (or should) tax all apples. A tax that fell only on MacIntosh or Golden Delicious apples would violate this neutrality norm — unless it could be recast as a normatively appropriate tax on MacIntosh or Golden Delicious apples alone, and so on. We cannot avoid considering the neutrality of each of the three principal taxes under consideration.

2. *Three Taxes, Three Neutralities*

The neutrality of an ideal income tax is familiar: It falls on all inflows, whatever the source. Broadly speaking, the sources of present or future consumption (consumption plus savings) are the returns to labor or capital, whether one's own or another's. Thus, gifts are certainly "income" in a Haig-Simons sense: they are resources available for consumption or savings.[128] Add in windfalls, or manna — found value — and the ideal income tax base is more or less complete.

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125. *Id*. at 175-82.

126. *Id*. at 183-84.

127. *See* Slemrod, *supra* note 12, at 159-62.

128. The income tax has never included gifts in gross income, though. *See* I.R.C. § 102 (2004). *See also* Douglas Kahn & Jeffrey H. Kahn, *"Gifts, Gafts, and Gefts" — The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441 (2003); Carolyn C. Jones, *Treatment of Gratuitous Transfers: Unraveling the Case for a Consumption Tax*, 29 ST. LOUIS L.J. 1155 (1985); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 102 (1992).

Any resources available for a taxpayer's personal use, whether they are presently consumed or saved, are taxed at the moment of inflow. Labor and capital market returns, and beneficent transfers, are the three primary sources of wealth. An ideal income tax would attach to all three.

This is a general norm of source neutrality. But, it is also — a point far less noted in the traditional tax-policy literature — one of use neutrality. Since sources equal uses (Equation [1a]), taxing all sources means taxing all uses. While Mill and Andrews each point out that an ideal income tax is not neutral relative to savers and spenders, that observation arises only in a dynamic, or two-period, model. An income tax is use neutral in a static, or one-period model: It simply does not matter, in the Haig-Simons definition, what one does with her available resources, any more than it matters from whence these resources came — you need not tell the government what you do with your income under an ideal income tax.[129] But as Andrews pointed out in his 1972 article, it is far from clear that we ought to have use neutrality in taxation: medical expenditures and charitable contributions may not strike us, for example, in reflective equilibrium, as the kind of uses we ought to be taxing.[130] So, too, not all uses of capital transactions are created equal. While the income tax is use neutral in a one-period setting, it is not neutral in a multiperiod one: Savers are "double taxed," whereas present spenders need not pay taxes again on any lingering psychic yield from their pleasures past.[131]

Prepaid consumption or wage taxes apply to all of one's own labor earnings, period. The yield to savings is never taxed, in the spirit of Mill's anti-double-tax argument. Nor are other people's capital, windfalls, or manna, taxed: All value must trace back to someone's labor earnings, at some point in time, when (and only when) it was taxed. A prepaid consumption tax puts pressure on sorting out the labor-capital (as well as the labor-beneficent) distinction, which can get tricky in hard cases. But it, too, is neutral, in theory, relative to its intended base: All and only labor earnings get taxed.

A prepaid consumption tax is not, therefore, source neutral; it ignores all sources other than own labor market earnings. But a prepaid consumption tax is even more use neutral than an income tax

129. Of course, you would need to tell the government how much of your *gross* receipts was spent on generating income, so that you would be taxed on your *net* income (the movement from I.R.C. § 61 (gross income) to § 62 (adjusted gross income) (2004), in sum), and therein many difficult issues of mixed business-personal expenses, timing, and so on would remain. But once we had gotten to this net figure, the resources available to you to save or consume, the government would be indifferent to your particular mixture of savings and consumption activities under a pure income tax.

130. Andrews, *Personal Deductions*, *supra* note 80; *see also* I.R.C. § 213 (2004) (extraordinary medical expenses); *id.* § 170 (charitable contributions).

131. Kelman, *supra* note 8.

because it is dynamically as well as statically use neutral, thus avoiding Mill's and Andrews's criticism of the income tax. It simply and consistently *never* matters what one does with her resources under a prepaid consumption tax, whether within a one- or a multi-period model. Even under variable and progressive effective or marginal tax rates, a prepaid consumption tax is "neutral" as between savers and spenders — Andrews's most sophisticated argument again — because of its consistent yield exemption. It preserves the pretax equality of present and deferred consumers, ex ante to the actual distribution of capital market returns for savers.

Progressive rates do, however, change things dramatically. Under progressive rates, neither the prepaid consumption nor the income tax is neutral as to the time path of labor market earnings, at least absent some averaging provision.[132] Taxpayers who earn their wages — or, under the income tax, receive any inflow — in relatively small, concentrated bunches will be hurt by progressive tax rates, vis-à-vis lower but steadier earners.[133] Artists, athletes, doctors, lawyers, and others with skills of limited temporal duration or high human capital requirements, and people who are dependent on whimsical consumer demand or other markets, will suffer on account of the interrelation between their patterns of labor market realizations and progressive marginal rates.[134] Most generally, any gap between inflows and outflows in constant real terms will increase one's average annual effective tax rate. This becomes a central theme in the new understanding of tax.

Finally, postpaid consumption taxes are neutral, too, and in a morally significant regard: They are neutral relative to the source of funds for financing present consumption. Since all that matters is the use — the fact of spending, or of "private preclusive use" as Andrews called it — postpaid consumption taxes are not use neutral, statically or dynamically, under progressive rates. They are not statically use neutral because savings are not taxed at all in the period of savings. They are not dynamically use neutral once we have relaxed the assumption of constant tax rates, by design. Some acts of savings will result in higher tax burdens than if they had not been engaged in; others will lower the burden of taxation. But in giving up use neutrality, postpaid consumption taxes find genuine source neutrality. Whether consumption is funded by labor or capital market returns, or

132. *See* prior law I.R.C. §§ 1301-05 (1982) (repealed 1986); *see infra* Part IV.E for a discussion of averaging.

133. Klein, *supra* note 14, at 463.

134. *Id*. at 470-79. *See also* BRADFORD ET AL., *supra* note 8, at 44; VICKREY, *supra* note 50, at 165-68.

by beneficent transfers, it is taxed at the same rates as all other consumption at the same level.[135]

Postpaid consumption taxes, in contrast to the two other comprehensive taxes, are indeed neutral as to the time path of labor (or capital) market earnings. It does not matter when a taxpayer earns or receives her lifetime resources; it matters only when she spends them. Thus, the person who earns a high salary over a short period of time — like the well-educated but highly worked lawyer — is not burdened vis-à-vis the slow but steady earner, given equal lifetime aggregate earnings and the use of capital market transactions to balance out the books.

In sum, an ideal income tax is both source and use neutral, although the use neutrality wanes in a dynamic setting, leading to Mill's critique. A prepaid consumption tax is not source neutral, as it ignores all but one's own labor earnings — it ignores all capital market earnings and beneficent transfers — but it is use neutral, both statically and dynamically. A postpaid consumption tax is not use neutral, because it differentiates between savings and consumption, but it is source neutral because it includes all sources of financing present consumption: labor, capital, and beneficence. Adding progressive rates into the mix adds an important dimension to the neutrality analysis. Progressive income taxes are not neutral as to the time path of inflows (earnings) or outflows (consumption); the former on account of the interaction between progressive rates and the base, the latter because of the double taxation of savings needed to effect certain patterns of consumption flows. Progressive prepaid consumption taxes are neutral relative to the time path of outflows (consumption) but not inflows (earnings). Progressive postpaid consumption taxes reverse this dynamic neutrality: they are neutral as to the time path of earnings but not of consumption. It does not matter under a progressive postpaid tax when or how one earns or receives her wealth; what matters — and all that matters — is when and how she spends it.

IV. A NEW UNDERSTANDING OF TAX

The critical step in attaining a new understanding of tax is putting progressivity in the rate structure first, as the foundational commitment of the comprehensive individual tax system, the primary means to achieve the end of a fair distribution of social resources. Things change once we presume progressivity in tax — once we no longer assume that the tax rate will be the same at the moments of first earning and of subsequent use. No longer are a prepaid and

135. *See* Andrews, *Reply to Professor Warren*, *supra* note 16, at 949-50.

postpaid consumption tax equivalent, even given constant rates of return and the relatively simple behavioral assumptions of the traditional view. A tax designer now faces three choices of income, prepaid, and postpaid consumption taxes, each with fundamentally different properties.

Under this new understanding, at least part of the "best, most sophisticated argument" for a consumption tax of the right sort is that it is a far better, and far more consistent, tax, *on the yield to capital*, under just the conditions in which it is fair and appropriate to tax such yield, than any other broad-based tax, certainly in practice and almost as certainly in theory. An ideal income tax double taxes all savings, whatever their use. A prepaid consumption tax never taxes savings, whatever their use. A consistent, progressive postpaid consumption tax — a progressive sales or spending tax, in short — burdens capital when savings and investments are used to enhance lifestyles (one's own or another's); but it does not burden capital when savings and investments are used to smooth out lifestyles (one's own or another's). A close, reflective reading of our tax practices reveals that this is what the actual tax system has been trying to do, but under the ill-fitting guise of maintaining an income tax: The nonideal income tax is at best a mishmash in regards to the taxation of capital and its yield.[136] Theory and practice happily converge under a consistent, progressive postpaid consumption tax.[137]

This argument structure stands the traditional view on its head: It argues for a consumption tax for the very reason that the traditional view clings to an income tax — to get at the yield to capital. The argument proceeds on both first-best grounds, namely that an ideal

136. *See infra* Part V.

137. This answers the question of whether the critique of the income tax and the argument for a progressive postpaid consumption tax throughout this Article is ideal, or first-best, as opposed to nonideal, or second-best, a confusion rampant in tax policy. My answer is both. The argument is that the problems with the actual income tax flow, in large part, from the failure of ordinary moral intuitions to support the income ideal; many of the inequities and distortions noted in Andrews, *Personal Income Tax*, *supra* note 8, followed from an unwillingness to tax all savings. By keeping to the form of an income tax while attempting to implement both the ordinary-savings and yield-to-capital norms, we created an incoherent nonideal system. A progressive postpaid consumption tax, on the other hand, implements the first-best ideals of the ordinary-savings and yield-to-capital norms, and so its nonideal, real-world instantiation will not be in conflict with its animating ideal. It is true, as some commentators have pointed out, that we may continue to want deviations from the taxation of all *consumption* under a postpaid consumption tax; there will continue to be arguments for medical expense and charitable contribution deductions, and so on. But recall that these arguments also apply to an income tax, which aims to tax all consumption and all savings. *See e.g.*, BRADFORD ET AL., *supra* note 8; MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 130-38, 148-50. There is no change, *ceteris paribus*, in the analysis of consumption terms. The progressive postpaid consumption tax simply puts the taxation of capital or savings on a more principled footing, implementing the yield to capital and ordinary-savings norms, and does so by design. Both the first-best and second-best arguments for such a resolution are compelling.

consumption tax is preferable to an ideal income tax, as a matter of fairness — specifically in terms of its fairness at getting at the yield to capital — and on pragmatic or second-best grounds, namely that the best obtainable real-world tax system is a consumption not an income-based one, again specifically insofar as the taxation of the yield to capital is concerned.

This Part sets out the analytics of the new understanding of tax, anticipating, at the same time, the normative argument for a consistent progressive postpaid consumption tax.

A. *Two Norms*

Critical reflection reveals two seemingly conflicting norms about the taxation of savings. In some cases, we desire to get at the yield to capital, contra Mill, because we view such yield as the domain of the socially fortunate. Those with more capital have more ability to pay, and more benefits received from the state, than those without capital. In other cases, pace Mill, we do not want to doubly tax savings, because savings is a normal, even laudable, activity in the course of an ordinary life, and it seems unfair to penalize savers but not consumers, Ants but not Grasshoppers. These two norms, introduced above as the yield to capital and ordinary-savings norms, respectively, are in tension — fatal tension — under an income tax, which is committed to double taxing all savings. Neither is met under a prepaid consumption tax, which ignores all savings. But the two norms come into perfect harmony under a progressive postpaid consumption tax, which can be understood precisely as implementing them simultaneously. This is not the only, or even necessarily the best, reason to favor such a tax, but it furthers the main point at hand: a commitment to progressivity in tax changes the traditional analysis of tax policy, especially in regard to the taxation of capital, and most advocates of an income tax should instead prefer a suitably designed consumption tax for the very reasons leading them presently to think otherwise.

1. *A Note on Reflective Equilibrium*

This is an argument, and an argument structure, that appeals to our enlightened common sense, one that can result in a reflective equilibrium, in Rawls's helpful epistemic term.[138] Such an equilibrium occurs when we have gone back and forth between relatively abstract political and moral theorizing, on the one hand, and paying close attention to our actual practices and ordinary moral intuitions, on the

138. RAWLS, *supra* note 52, at 19-21, 48-51. Actually, Rawls credits Nelson Goodman with the development of the term and concept. *Id*. at 20 n.7 (citing NELSON GOODMAN, FACT, FICTION AND FORECAST 65-68 (1955)).

other; theory is checked by practice, and vice versa. This style of thinking looks to our actual practices for source material to interpret the way to a better — fairer — set of rules.[139] It is a mode of analysis familiar to lawyers and law students reasoning in the domains of common and constitutional law — where practitioners of the method read cases to try to discern principles within them that they then endeavor to render consistent from a theoretical point of view — but curiously absent from our thinking about tax.[140] Yet precisely the same style of analysis can open up promising avenues for reform obscured by more conventional approaches. Consider the following abstract and admittedly stylized account of where we are in tax, and how we got here.

Theory, at first, suggested some form of redistributive taxation to help effect social justice while financing important public goods — including possibly the redistribution of income itself. This is a plausible, compelling end for tax. But a commitment to progressive or redistributive taxation is not nearly specific enough. Society still must answer each of the inevitable questions of tax: *what*, *when*, *whom*, *how*, and *how much*. Theory suggested an income tax as the best vehicle for redistribution, precisely because such a tax reaches the yield to capital, which is nearly the exclusive domain of the socially fortunate. Theory had read Mill;[141] the base argument was born. At an early historical moment where theory dominated — there was after all a paucity of practice at the time — the United States adopted an income tax. It was a limited tax, with modest and modestly progressive rates on the economically privileged few.

Practice grew up in the shadows of this prior theory. But over time, these practices — nearly one hundred years of them by now — began to show an unease with the very idea of an income tax, especially as both tax rates and the breadth of the tax's application increased far beyond their initial bounds. As the tax grew from its humble roots, compromises and deviations piled on each other, generating over time a badly flawed tax, with multiple holes in its commitment to taxing the yield to capital. Unreflectively, as is its way, practice tried to patch up these holes, as by adding on corporate income and wealth transfer taxes to the income tax as "backstops" to its inherent desire to tax the

139. *See generally* RONALD DWORKIN, LAW'S EMPIRE (1986); Gregory C. Keating, *Rawlsian Fairness and Regime Choice in the Law of Accidents*, 72 FORDHAM L. REV. 1857 (2004); Edward J. McCaffery, *Tax's Empire*, 85 GEO. L.J. 71 (1996) [hereinafter, McCaffery, *Tax's Empire*].

140. I am here following a methodology I have laid out elsewhere, one that consciously draws on a model of normative constitutional and common law argument. *See* McCaffery, *Tax's Empire*, *supra* note 139.

141. *See* MILL, *supra* note 1. For an overview of the history of the desire for progressivity in tax, see Jensen, *supra* note 4; Bank, *supra* note 4.

yield to capital. The system attempted to close some of the widening loopholes to clamp down on certain attempts to avoid its theoretical commitment to taxing the yield to capital, such as through complex rules regarding "original issue discount" and so on,[142] while at the same time widening the holes in other cases, as through provisions for tax-favored savings accounts.[143]

Confronted with practical incoherence and conflict, we return to theory. Theory sees that something has gone badly awry in the progressive income tax — that is why we are where we are, reflecting over what to do next. Some take this as an occasion to argue against progressivity itself. Theory will soon see that this is a mistake. For one thing, rather little of the practical morass of tax is directly traceable to the decision to have progressive tax rates.[144] More important, our normative commitment to at least moderate progressivity in tax burdens remains as solid as ever: indeed, a large part of the disillusionment with tax relates to the sense that the rich are, in fact, not paying their fair share, and that the burdens of tax fall all too heavily on the middle, laboring classes.[145] Progressivity is an end, ill-served by the means of the present tax system; we have not changed our ends. Further, this sense of unease with the status quo, however inchoate it is, is right in its factual predicates, and directly related to deep structural features of the so-called income tax — this is a lesson that theory can learn from a detailed consideration of our practical tax system, as considered further below.[146] Clinging to a commitment to progressivity is not a scholarly fiat: political attempts to cash in on disdain for the progressive income tax with a flat tax of some sort have not, in fact, resonated with the people.[147]

If progressivity is to remain, theory next considers whether something is wrong with the "income" part of the progressive income tax. Here, indeed, things have gone amuck, and the practical mess relates almost entirely to the erratic treatment of savings or accumulation, a point that Andrews had seen and made forcefully

142. *See, e.g.*, I.R.C. §§ 1271-1275 (2004) (o.i.d. rules); *see also* Halperin, *supra* note 73.

143. *See, e.g.*, I.R.C. §§ 401 (qualified pension plans), 408 (traditional IRAs), 408A (Roth IRAs) (2004); see *infra* Part V.B for an analysis of the current system's ad hoc deviations.

144. Bankman and Griffith make this point well. *See* Bankman & Griffith, *Debate*, *supra* note 12; Bankman & Griffith, *Social Welfare*, *supra* note 12.

145. In a 2003 CNN/Gallup/USA Today poll, 63 percent of respondents thought the rich pay too little in taxes, while only 7 and 12 percent, respectively, thought middle- and lower-income taxpayers pay too little. KARLYN H. BOWMAN, AMERICAN ENTERPRISE INSTITUTE, PUBLIC OPINION ON TAXES 18 (2004), http://www.aei.org/publication16838 (last visited Jan. 14, 2004); *see also* GRAETZ, *supra* note 6, at 10-13; SLEMROD & BAKIJA, *supra* note 7, at 5; Graetz, *supra* note 6, at 282-83.

146. *See infra* Part V.

147. *See supra* notes 106-110 and accompanying text.

nearly three decades ago — theory reads law review articles.[148] We are not, in fact, taxing all savings equally. Worse, the practical compromises we have made are theoretically incoherent, leading to the sorry state of affairs in which we fail to tax consumption financed out of the yield to capital, and cannot even predictably induce more savings, on an individual or an aggregate social level, when we try.[149]

And so theory asks an obvious question: Should we be taxing the yield to capital? This is the question at the core of the income-versus-consumption debate, which has been needlessly, and unfortunately, all-or-nothing. Theory sees that a prepaid consumption tax, namely, a wage tax, can never get at the yield to capital, within or between generations. This bothers theory; it seems to violate a core reason to want progressive individuated taxes in the first place. But theory also sees Mill's point, and the practical resistance against a willy-nilly double taxation of all savings. Theory sees much principle in the income tax's consumption tax provisions, such as for retirement savings, and so becomes disenchanted with the extremes in the debate. Should we be taxing all yield to capital in the same manner? Is it the case that all savings are created equal? Are we equally normatively committed to double taxing — or altogether exempting — all forms of savings, as the stark income-versus-consumption tax debate would have it? If not, is a principled middle ground practically obtainable?

2. *The Norms of Capital*

Asking just these questions brings theory to a critical epiphany. It leads abstract theory to understand what practice has been trying inchoately and imperfectly to express for scores of years by now. We do, in fact, want to burden some but not all savings. Further, on reflection, we see that our best normative judgments and ordinary moral intuitions flow naturally to the uses and not to the sources of such savings.[150] It is not, that is, that our reflective judgments counsel for taxing those savings that come from stocks versus bonds versus real estate and so on differently. Here, I put aside the far lesser in

148. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1128-29.

149. The reason is that it is possible to save on the one hand and borrow on the other, resulting in a deduction with no net savings, or to move existing savings into tax-favored accounts, thereby obtaining a similar bottom-line result. *See* Edmund L. Andrews, *Savings: Lots of Talk, but Few Dollars*, N.Y. TIMES, Mar. 13, 2005, at § 3, p.6; Elizabeth Bell, Adam Carasso, and C. Eugene Steuerle, *Retirement Saving Incentives and Personal Saving*, 105 TAX NOTES 1689 (2004) (reporting that tax breaks for retirement programs cost $112 billion in 2004, according to the Office of Management and Budget; personal savings, for all purposes, totaled $100.8 billion).

150. *See* McCaffery, *Hybrid*, *supra* note 23, at 1148 (arguing for a hybrid income-consumption tax "because of the different values we place on the different types of savings").

magnitude, and more technical or economic, question of whether or not, in some special instances, because of market failures or for some other reason, we actively want a tax-based policy of inducing capital to flow to certain uses or areas, such as "empowerment zones."[151] These are technical questions best left to technical experts. Theory is, in contrast, crafting the broad contours of a socially just comprehensive tax system; we are getting the individuation of tax down right, in the spirit of Vickrey. Of course, tax can do other things, such as correct for market failures here and there. But the task of the major comprehensive individual tax system as a central component of a just social structure is wider and deeper than ad hoc corrections for market failures.

Back to the broader strokes of comprehensive tax policy: It strikes our ordinary moral intuitions that some uses of savings — paradigmatically, for retirement, but also for medical and educational needs, and so on — are appropriate on an individual and, perhaps, a social level, and, if anything, ought to be encouraged, certainly not double taxed. Other uses of savings — as to enable grander lifestyles, in this or later generations — strike us as not deserving of our sympathies in the same regard. How can theory reconcile these seemingly opposing intuitions? To further advance its practical project, theory needs a better, more specific, understanding in regard to the competing ideas about savings manifest in today's tax system. On critical reflection, the two distinct norms anticipated above emerge. Note that these are norms about the taxation of the activity of savings, that is, about the flow of funds going into and out of a taxpayer's household, as befits Mill's focus on such flows and Andrews's focus on uses. Different norms might apply to the stock of capital, that is, to the very possession of wealth, or to how and where the value is invested. I shall revisit these concerns later.[152]

One norm is that capital and its yield, as a general matter, ought to bear some tax; those fortunate enough to be able to live off interest, dividends, capital gains, and so forth ought not be further privileged by way of exemption from the public-regarding burdens of tax. This is the yield-to-capital norm. Indeed, if anything, there is an urge to tax the yield to capital more than the yield-to-labor. The general intuition behind the yield-to-capital norm is reflected in the very choice of an income tax, as we have seen, and in the periodic attempts to plug up

151. Empowerment zones are regulated by I.R.C. §§ 1391-1397D (2004). Of course, such regulations have complicated and sometimes counterproductive effects. *See* Jeffrey S. Lehman, *Updating Urban Policy*, *in* CONFRONTING POVERTY 226, 228-30 (Sheldon H. Danziger et al. eds., 1994); Jeffrey S. Lehman & Timothy M. Smeeding, *Neighborhood Effects and Federal Policy*, *in* 1 NEIGHBORHOOD POVERTY: CONTEXT AND CONSEQUENCES FOR CHILDREN, 251, 259-62 (Jeanne Brooks-Gunn et al. eds., 1997).

152. *See infra* Part VII.B.4.

certain "loopholes" in the actual income tax's commitment to taxing the yield to capital. This intuition is also shown in the misguided, if understandable (given the traditional view of tax), categorical resistance to any comprehensive conversion to a consumption base. The yield-to-capital norm is further manifest in the insistence on maintaining separate gift and estate, and corporate income taxes: an insistence that may well also be misguided, on the better view of tax's possibilities. The more particularized intuition that the yield to financial capital ought to bear, if anything, a higher burden than labor earnings, or the yield to human capital, reflects an ordinary moral intuition that such financial yields come more easily, without the psychic disutility of physical work. These attitudes were widespread at the time of the adoption of the modern income tax, and they sensibly fit with the choice of that tax.[153] We can understand the yield-to-capital norm as a vertical equity one: it reflects an intuition that the yield to capital is a privilege of the economically fortunate.

A second norm, seemingly inconsistent with the first, is also evident in our practices of tax. This is the ordinary-savings norm, which rests on an intuition that some savings are different. Broadly, these are the savings that take place — or ought to — in the ordinary course of an ordinary life. Savings for one's own retirement, for one's children's education, for medical and other emergencies, fit into this norm. There is a strong and widely held intuition that such savings should not be subjected to Mill's double tax, whether or not proponents of the norm are aware of the canonical mappings of traditional tax policy. Such savings should be encouraged, if anything, and certainly not discouraged. To reconcile the ordinary-savings norm with the yield-to-capital norm, in theory, we can understand ordinary-savings as moving the yield to human capital — that is, labor earnings, wages — evenly through time. The ordinary moral intuition to burden the yield to financial capital more than the yield to human capital, as the latter involves psychic disutility to work (and so on), does not extend so compellingly to labor earnings that are simply saved at a normal rate of return for some later day. This distinction will become clearer in the next section, with a practical analytic vocabulary regarding the uses of capital transactions before us.

In any event, the ordinary-savings norm is, of course, reflected in the many provisions of the law that favor (or do not disfavor) such savings: pension plans such as 401(k) plans, IRAs of various types, medical and education savings accounts. These elements began in the 1940s.[154] A large and very important trend of the 1990s was the expansion of such prosavings provisions. (The fact that some such

153. *See generally, e.g.*, Bank, *supra* note 4; Jensen, *supra* note 4.

154. *See infra* note 254 and accompanying text.

provisions are structured along a prepaid model, as in the "Roth" IRAs, while others continue to come in a postpaid fashion, as with "traditional" IRAs, is yet another sign of the analytic muddle of tax.[155] This move towards prepaid and away from postpaid consumption taxation has also characterized the contemporary conservative assault on progressivity in tax.) In any event, in the traditional normative language of tax policy, we can see this second norm as a horizontal equity one. "Ordinary" savers are not the privileged elite. Rather, they are regular workers choosing to do a perfectly sensible — indeed, admirable — thing with some of their earnings: save them for a later, perhaps rainy, day. Here, the familiar pair-wise comparisons carry normative force: Why should the thrifty Ant be taxed more heavily than the spendthrift Grasshopper, when both have the same resources as of a critical moment in time, and when Ant is actually doing what a reasonable society should want her to do at that time?

There is another and important sense in which this ordinary-savings norm reflects a horizontal equity perspective. It is that the vertical equity judgments made by the basic rate structure — and the choice of an income tax, with its yield-to-capital norm — ought not fall on individuals only temporarily elevated into the higher "ability to pay" or high tax-rate regions because of morally arbitrary patterns of labor market earnings. In order to make sure that we are taxing equals equally under the progressive rate structure — in order to best (most fairly) determine who are indeed "equals" — we need a wider time frame than the arbitrarily chosen twelve calendar month one of practical tax administration.[156]

The yield-to-capital norm was present at the dawn of the income tax: It was a large part of the reason for choosing such a tax. The ordinary-savings norm favoring — or, perhaps better put, opposed to disfavoring — certain classes of savings, in contrast, became apparent much later, after income tax rates had risen and the tax's breadth had expanded to reach the majority of adult Americans.[157] It was then that the horizontal equity issues became problematic; it was then that the call to escape Mill's curse became more clarion. But herein seemingly lay a rub: The ordinary-savings norm is inconsistent with the choice of an income tax, made to further the yield-to-capital norm. As a practical matter, the coexistence of the two norms about capital and its yield under a nominal income tax has generated a highly flawed status quo. As an analytic matter, it has left us in the grip of incoherence. The particular center we have chosen cannot hold.

155. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 50.

156. *See generally* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX (1986); BRADFORD ET AL., *supra* note 8; VICKREY, *supra* note 50; Daniel Shaviro, *Endowment and Inequality*, *in* TAX JUSTICE 123 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

157. *See* Jones, *supra* note 65.

Now, theory has a sharpened practical question to ponder: Is it possible to design a tax system that gets at some, but not all, of the yield to capital, in just the way we want it to? That does, consistently and logically, what our imperfect real-world tax system attempts to do inconsistently and illogically? That is, a tax system that implements the yield to capital and ordinary-savings norms concurrently?

Surprisingly — especially to those in the grip of the traditional view — the seemingly inconsistent popular attitudes towards savings can be rendered perfectly coherent and consistent under a properly designed tax system. Those forms of savings that ordinary moral intuitions favor are precisely those that smooth out life-cycle consumption: that move wealth from high-earning periods into lower-earning ones, such as retirement, or into those of greater urgency or objective need, such as times of increased education or medical expenses.[158] At the same time, the urge to tax some of the yield to capital plausibly relates to material resources used to finance higher standards of living, namely, greater discretionary expenditures, within or between individual lifetimes. How can we relatively favor the one form of savings, which smoothes out labor earnings, while not favoring the other, which enhances lifestyles? It turns out that a progressive postpaid consumption tax does exactly this. It is the mechanism of progressivity under the tax that does the bulk of the normatively desired work.

B. *Two Uses of Capital*

The analysis of the prior section suggests an analytic distinction not presently drawn in the tax policy literature. Capital transactions — borrowing, saving, and investing — can in fact be put to two broad (and analytically exclusive) uses within a taxpayer's lifetime. One is to smooth out one's labor earnings, which are earned over a limited period of years, into a steady consumption pattern over one's entire life. This smoothing perspective solves a certain personal financial equation: it sums up an individual's earnings in constant dollar terms, and then divides this total by the years in one's life. The result of this exercise is to generate the same level of consumption, in real dollar terms, for each year of life; it balances out an individual's books, so to speak, as if her life were self-contained and devoid of any windfalls, gifts, and the like. Smoothing effectuates the ordinary-savings norm.

The other use of capital transactions is, in short, to do anything other than smooth out earnings. Capital transactions can shift consumption patterns: to make one better (or worse) off than she could be on the basis of labor market earnings alone, for certain

158. For a philosophical discussion of urgency and objective needs, see T.M. Scanlon, *Preference and Urgency*, 72 J. PHIL. 655, 660-61 (1975).

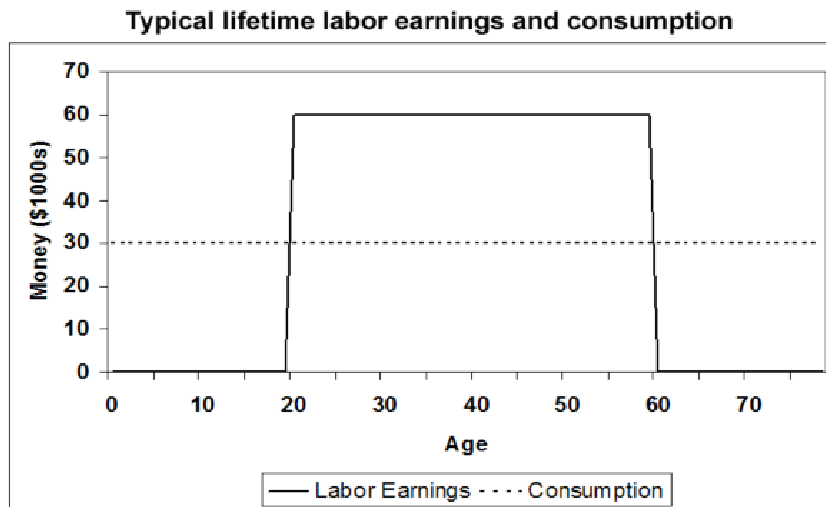
periods of her life or throughout her entire life. Consumption shifting corresponds to the yield-to-capital norm.

A simple graphical example helps to see these points.

1. *An Untypical Picture of a Typical Life*

Figure 1 shows, in stylized and financial terms, how many of us live. The solid line shows labor earnings, while the dotted line shows spending or consumption. Simply to get an easily tractable example, Figure 1 reflects a world with no inflation, which solves the problem of translating fluctuating nominal dollars into constant real ones.[159] There are also no taxes — yet — in the story.

FIGURE 1



The hypothetical taxpayer in the figure lives for 80 years. She works for 40 of those years, from age 20 to age 60, but, of course, she consumes for all 80 years. Assume that she has no benefactors, such as parents, and no beneficiaries of her largesse, such as children; she acts as a self-contained financial unit, balancing her books of inflows and outflows within her lifetime alone. Later I shall relax this assumption, with a corresponding expansion in generality of the normative points.

159. The assumption does not materially affect the analysis. Inflation can be generally accounted for by indexing the rate brackets, which is how progressivity will be achieved: Fully indexed, the system maintains a constant effective tax rate on constant real value dollars, as the no-inflation assumption also effects. Further, under a progressive postpaid consumption tax, the full deductibility of principal and interest washes out the time value effects at least at the normal rate of interest.

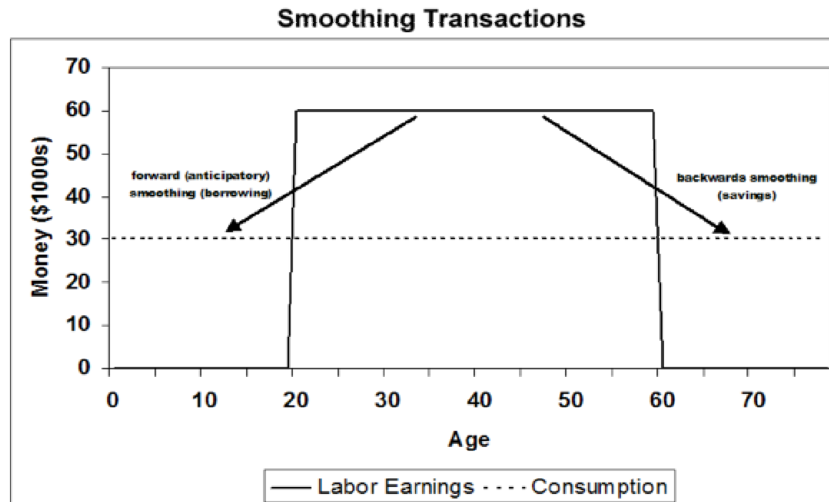
In any event, during her labor market earnings years, the taxpayer makes a constant $60,000; throughout her life, she spends $30,000 annually. In such a fashion she can balance the books, with her $2.4 million of lifetime earnings and spending.

2. *Smoothing Transactions*

The stylized picture of Figure 2 adds onto Figure 1 to show one very important use of capital: to smooth out consumption patterns over a lifetime. The hypothetical taxpayer effectuates this smoothing by capital transactions. She borrows $30,000 a year for the first quarter, or 20 years, of her life, at 0 percent interest.[160] For the second quarter, the first 20 years of her working life, from age 20 to 40, she pays off this debt at the rate of $30,000 a year, living on her remaining $30,000 annually. For the third quarter, the final twenty years of her working life, from age 40 to 60, she sets aside $30,000 a year for her retirement, once again, in the simplifying assumptions of the story, at no nominal interest, and spends the remaining $30,000. When she retires at age 60, she draws down her retirement savings to finance continued consumption during her last quarter of life, once again at the rate of $30,000 a year.

160. This is, of course, a simplifying assumption, but it does not affect the analysis. Recall the 0 percent inflation in the story; at a positive rate of inflation, the wages would be higher to reflect the inflation in the principal of the debt. Consider also that many loans are intrafamily transfers, as I shall discuss below. Any real interest, in fact, reduces the amount of lifetime consumption (below the posited $2.4 million in the example), but then any real positive rate of return on the savings in the third and fourth quarters of the taxpayer's life increases it.

FIGURE 2



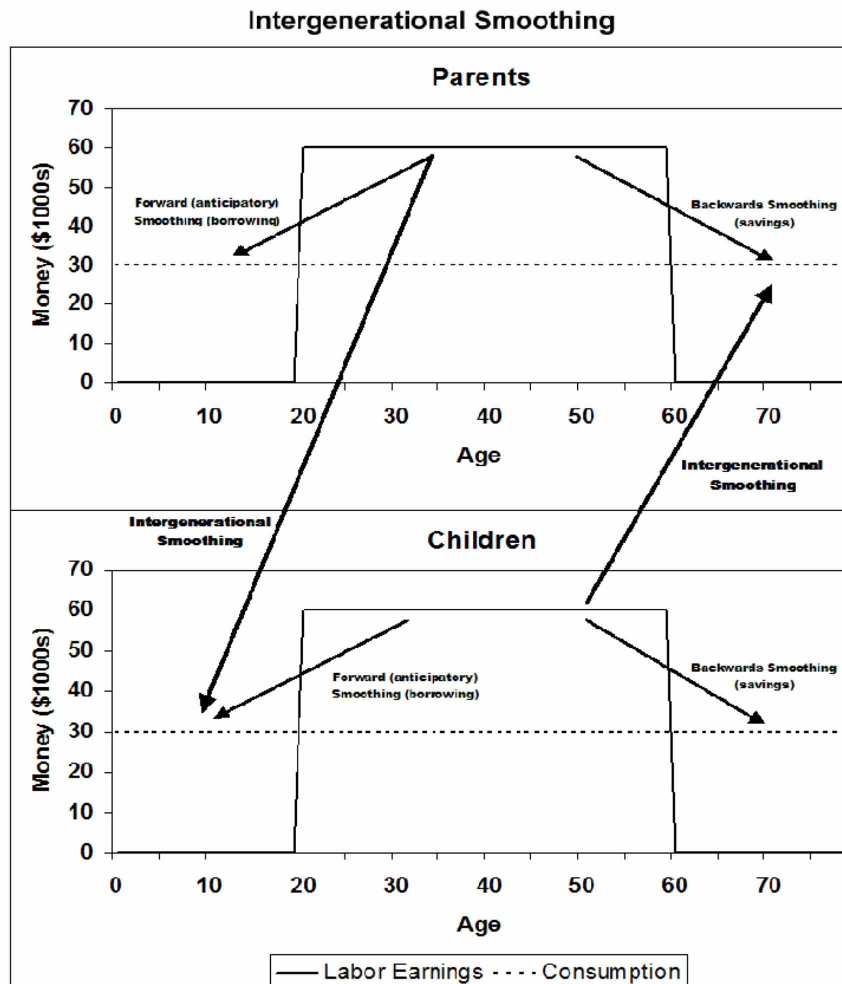
In this stylized example, we see that both "normal" borrowing and savings transactions — those that carry a normal rate of interest, principally (and in the simplified example, exclusively) compensating for inflation — help the taxpayer to smooth her consumption pattern. Borrowing shifts labor earnings forward in time, so that one can consume before she earns; savings shift them back, so that one can continue to consume after she ceases to earn. In Figure 2, with no inflation, the taxpayer will simply borrow $30,000 a year for the first 20 years of her life, pay this debt off over the next 20 years, save $30,000 for the next 20 years, and draw this down for the final 20 years.

In a simple setting with perfect knowledge, no transaction costs — and no other humans in the picture — the smoothing of Figure 2 can be achieved by well-functioning financial capital markets. Of course, the world is not so perfect. In its imperfection, smoothing does not occur so precisely. In practice, families often function as annuities, insurance, and other capital markets.[161] By social norm or otherwise, our parents pay for our consumption in our youth; we may or may not pay them back in later years, but in any event, we are expected to pay

161. Laurence J. Kotlikoff, *Intergenerational Transfers and Savings*, J. ECON. PERSP., Spring 1988, at 41, *reprinted in* WHAT DETERMINES SAVINGS? 68 (Laurence J. Kotlikoff ed., 1989); Laurence J. Kotlikoff & Avia Spivak, *The Family as an Incomplete Annuities Market*, 89 J. POL. ECON. 372 (1981), *reprinted in* WHAT DETERMINES SAVINGS? 88 (Laurence J. Kotlikoff ed., 1989); Laurence J. Kotlikoff & Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation*, 89 J. POL. ECON. 706 (1981), *reprinted in* WHAT DETERMINES SAVINGS? 43 (Laurence J. Kotlikoff ed., 1989).

for the consumption of our children in their early years. Families also provide important mortality insurance should grandparents outlive their finances, and so on. In an "overlapping generations" model, as illustrated in Figure 3, the smoothing of consumption shown in Figure 2 occurs between generations.[162]

FIGURE 3



This Figure adds a second generation to the smoothing transactions of Figure 2. The darkened arrows indicate transfers across generational lines, from parents to children, or vice versa. The story

162. Robert J. Barro, *Are Government Bonds Net Wealth?*, 82 J. POL. ECON. 1095, 1116 (1974); Kotlikoff, *supra* note 161; Kotlikoff & Summers, *supra* note 161.

behind Figure 3 is a common one, where parents help their children in their youth, and then these same children help their parents — paying them back, in essence — in their old age. Another familiar story of intergenerational annuities markets is where parents continually help their children, so the support received from one's parents is turned over to the third generation, as it were, in an infinitely overlapping generations model. The idea here is to sketch out rough possibilities; note that these intergenerational transfers can be smoothing or shifting.

Smoothing is simply an analytic possibility that almost all wage earners engage in to some extent: one has to smooth, somehow, if a limited period of labor market earnings is to support a full lifetime of consumption, unless one is a significant beneficiary of some sort (more on this, which affects the yield-to-capital norm, anon). What is morally significant to theory is that smoothing strikes our ordinary moral intuitions — as reflected, in fact, in the practices of the actual income tax — as a perfectly normal and appropriate thing to do. Smoothing effects the ordinary-savings norm. A reasonable political and moral theory can certainly accept this norm revealed from practice, bringing about a reflective equilibrium; Mill and Rawls seem to have done so, for example. Smoothing balances out the morally arbitrary ups-and-downs of labor markets.[163] Adding progressivity into the mix — as the first, foundational commitment of the comprehensive tax system's claim to justice — makes this critically important. Income and prepaid consumption (wage) taxes fall on the unsmoothed lines of Figures 1-3; postpaid consumption (spending) taxes fall on the smoothed lines. Under progressive marginal or effective rates, taxpayers pay more tax based on the particular pattern of their earnings profile under prepaid consumption or income taxes, but not under a postpaid consumption tax, when they engage in ordinary smoothing activities.

It is for these reasons that many scholars have long advocated taking a "lifetime" perspective on the imposition of tax burdens. This is an idea advanced by Vickrey, through a very clever proposal for the lifetime averaging of tax burdens, and picked up in recent years by those, such as David Bradford and Daniel Shaviro, discussing

163. BRADFORD, *supra* note 156; BRADFORD ET AL., *supra* note 8; VICKREY, *supra* note 50. Of course, the position that these ups and downs are indeed morally arbitrary requires argument, which this Article does not provide in any length or depth. Suffice it to say that it is hard to imagine a compelling moral argument that a putative taxpayer should pay more taxes strictly on account of her uneven pattern of labor market earnings vis-à-vis an equal but steadier earner, yet a system of progressive average rates has precisely this effect under a prepaid consumption or income tax. The practical prevalence of the ordinary-savings norm — the widespread allowances under the "income" tax for backward smoothing — further testifies to the moral insignificance of particular patterns of labor market realizations.

"endowment" taxes.[164] The smoothed perspective looks to this lifetime average: What is significant is the $2.4 million of lifetime consumption spread over 80 years, not the particular — and generally morally arbitrary — pattern of earning it. Any tax on inflows, such as a prepaid consumption or an income tax, that does not somehow allow for smoothing is penalizing those whose human capital gets realized in short periods and in bunches — artists, athletes, doctors, and lawyers, say — vis-à-vis more regular, steady lifetime earners. This point was anticipated, in traditional horizontal equity terms, by Andrews, and developed by William Klein.[165] Indeed, Mill's double-tax critique is most compelling when a taxpayer is simply trying to break even within her lifetime, and so too with Andrews's "most sophisticated" argument for consumption tax.

By moving to a lifetime perspective, allowing smoothing to lower tax burdens reflects as much a "vertical" as a "horizontal" equity norm. If we base a tax on outflows, thereby allowing people to smooth, and assume (only for now) no net transfers in or out of the taxpayer's combined, total pool of resources available for her own personal lifetime consumption, then a taxpayer can solve a personal tax minimization problem by perfect smoothing. Note that rough or imperfect smoothing comes out much the same way, on account of the width of the progressive marginal rate brackets: there is no need for taxpayers to be precise actuaries.[166] Taxes are then set — equals are then measured — on the basis of this smoothed consumption line, reflecting a sustainable standard of living across a lifetime. Rather than a single year, or a short period of years, of high earnings elevating one into higher tax brackets, it is this smoothed, sustainable pattern of consumption that sets one's level of taxation. Then those who, after smoothing their labor earnings, are able to live a more costly lifestyle, are taxed more than those who are not: these are, necessarily, people who have enhanced their consumption by capital market returns or beneficent transfers. "Equals" are measured by their lifestyles; lifestyles are financed by labor, capital, and beneficent transfers, and the consistent postpaid consumption tax does not mark the distinctions among sources.

The smoothed perspective as a measure of taxable ability is appealing to ordinary moral intuitions and in reflective equilibrium: it

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164. *See* Bradford, *supra* note 156; Shaviro, *supra* note 156. Note that these ideas are predicated on individual levels; a somewhat parallel macroeconomic idea can be found in Laurence Kotlikoff's and others' writings on "generational" accounting. *See supra* note 161.

165. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1170; Andrews, *Reply to Professor Warren*, *supra* note 16, at 957-58; Klein, *supra* note 14; Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 Yale L.J. 283, 350-51 (1994) [hereinafter McCaffery, *Uneasy Case*].

166. *See infra* note 193 and accompanying text.

happens to map up perfectly with a postpaid consumption tax, but the argument is not a matter of semantic definitions. It is not, that is, the case that a postpaid consumption tax is independently desired for some reason and therefore that smoothing becomes the appropriate normative baseline against which to discuss increasing or lowering tax burdens. It is, rather, that smoothing strikes us as an appropriate normative baseline, because it does not take into account the morally arbitrary pattern of labor market earnings on a year-to-year basis, but rather rests its decisions about taxability on a sustainable lifetime pattern of consumption. A postpaid consumption tax implements this norm.

3. *Shifting or Enhancing (Diminishing) Transactions*

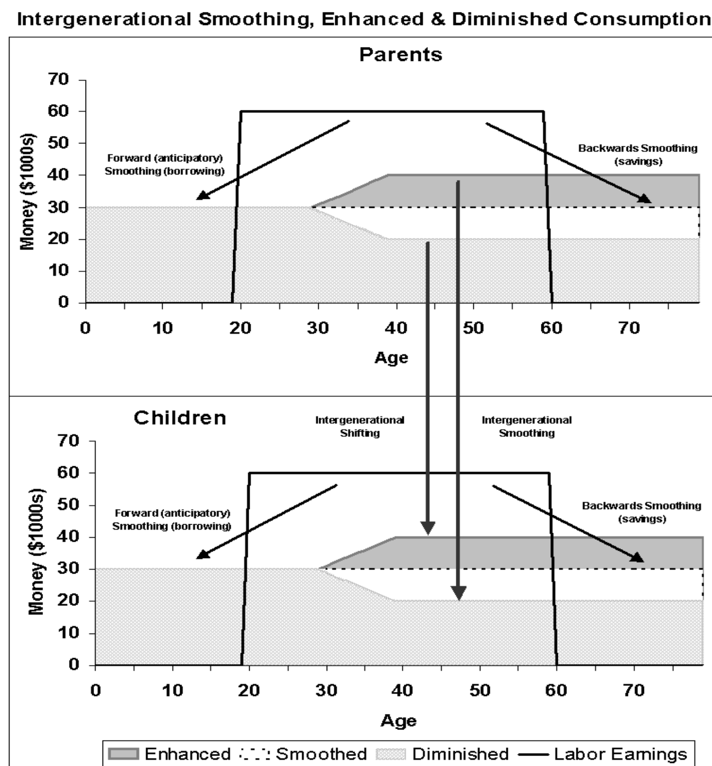
A second use of capital and its yield, already anticipated, is to change one's average level of lifetime consumption: to enhance or increase one's lifestyle by spending out of "surplus" capital funds, or to diminish it by being a net saver throughout one's life or by transferring wealth to others — personal or institutional (e.g. charitable) beneficiaries. Shifting is the complement to smoothing. Smoothing takes the taxpayer's average labor market earnings in constant real dollar terms as its baseline. Shifting moves this baseline up or down.

In moving from a description of capital transactions to a normative position, a norm of self-sufficiency emerges: Capital transactions that are "simply" and "normally" translating uneven (by time) labor market earnings into even, smooth cash flows should not bear the sting of Mill's double tax or, indeed, any positive tax burden at all. In the simple smoothed profile, there is no "luck" in the capital markets, no largesse from or to any other individual. Smoothing is what an ordinary person can do, with the fruits of her own labor, and access to normal, well-functioning capital markets with little or no risk. But capital transactions can change things, too. One can do better or worse than the smoothed profile, by being the beneficiary of good luck or someone else's largesse, or by being the recipient of bad luck or a net benefactor to others.

Figure 4 presents a simple picture to illustrate this. Figure 4 adds onto Figure 3's intergenerational example the possibility of taxpayers, within or across generations, living on more or less than what their average annual labor market earnings in constant dollar terms would allow. Beginning at age 30 in each generation, the Figure shows "enhanced" consumption, where a taxpayer is living at $40,000 a year, more than her average annual labor market earnings, in constant dollar terms, and a "diminished" consumption pattern, where the taxpayer is living at $20,000 a year, below her average annual labor market earnings. The intergenerational setting helps to illustrate that

there are several sources of this enhanced or diminished consumption profile. Good fortune in the capital markets — supranormal returns, in the language of recent tax policy analysis[167] — is one. Intergenerational transfers can also either elevate or diminish consumption patterns, and altruism — transfers to charities — can diminish them.[168] Diminished consumption might result from a simple mistake, a failure to "die broke" out of an excess of caution, a failure of annuities markets, or a combination of all three factors.[169] It could also result from bad luck in the capital markets: from a failure to earn even normal returns on savings, or excessive payments for the use of capital early in life.

FIGURE 4



167. *See generally* Bankman & Griffith, *Debate*, *supra* note 12; Alvin C. Warren, Jr., *How Much Capital Income Taxes Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996).

168. All this depends, of course, on supporting the semantic claim that such personal or institutional (charitable) giving is not "consumption;" a position that the present income tax law takes, at least relative to charitable giving. *See* Andrews, *Personal Deductions*, *supra* note 80, at 346.

169. STEPHEN M. POLLAN & MARK LEVINE, DIE BROKE (1997); *see also* Kotlikoff & Spivak, *supra* note 161, at 372-73.

A compelling case can be made that the enhanced lifestyle profile is "vertically" above the smoothed one: anyone who has received additional resources to consume, one way or another, is in fact more "able to pay" than someone who has not. Indeed, this is an animating norm of an ideal income tax, a logical concomitant of Henry Simons's (and many others') "source neutrality" norm. It is more arguable that the "diminished consumption" profile represents a lower rung on the vertical equity, or "ability to pay," ladder; an ideal income tax generally treats people on the basis of their potential to consume[170] or, somewhat equivalently, treats savings, gifts, bequests, and even many capital market losses as instances of consumption. But note that, under a consistent, progressive postpaid consumption tax, the diminution in private consumption must be permanent, across generations, to result in a lesser tax burden. In lying in wait for ultimate private preclusive use, the progressive postpaid tax holds out the possibility — by design — of an increased tax burden on certain patterns of intergenerational transfer.[171]

Now it is time to ask a pressing question: Why should the norms of capital apply *inter*, as well as *intra*generationally? This is a point that distinguishes a consistent progressive postpaid consumption tax from a progressive income tax with averaging, as discussed below. Once more, second-best concerns loom large: policing and taxing intergenerational transfers is hard. But still as a matter of first-best theory, and with the various pictures to help us, we can see that intergenerational transfers, like intragenerational savings, also differ in their intended and ultimate uses. Much intergenerational transfers smooth across generations, making for within-family annuity markets. Such transfers can save on certain transaction costs compared to third party mechanisms, and there is no compelling reason to burden them with a double or even triple tax, on transfer. Other transfers simply bring children up to a lifestyle level closer to their parents, arguably maximizing utility.[172] Yet other transfers create dynasties, allowing generations to live off the yield to capital, without labor. The current system, with a wealth transfer tax rife with exceptions, once again reflects two norms, one allowing, the other seeking to tax, these transfers,[173] but implements them erratically, at best. A consistent

170. *See* Warren, *supra* note 13, at 934.

171. In this way, the progressive postpaid consumption tax acts as an accessions tax, falling on heirs. *See* McCaffery, *Being the Best*, *supra* note 15, at 631. Of course, this might not address all of the concerns of advocates of wealth transfer taxation, because the postpaid consumption tax can facilitate greater stores or stocks of private wealth. I discuss this issue *infra* Part VII.B.4.

172. *See* Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469 (1995).

173. *See infra* Part VI.B (criticizing current wealth transfer tax system).

progressive postpaid consumption tax perfectly implements both norms, at the same time, and across as well as within generations.

Back to the reasons for diminished consumption at the parental, or putative donor's level: The parent who self-sacrifices to enable her child to live an enhanced lifestyle is not solving an intergenerational tax minimization problem; she is like the intragenerational taxpayer who fails to smooth. Her family's total tax burden will go up, in constant dollar terms, on account of her financial behavior. The progressive postpaid consumption tax — consistent with its focus on uses, or the right-hand side of the Haig-Simons identity — differentiates among the reasons for diminished lifestyles. Those who have had bad luck in the capital markets, or who are benefactors of qualified institutional charities, say, will see their and their family's tax burdens go down; those who are building private dynasties will see their familial tax burdens increase. While an ideal income tax would also adversely affect private dynasty creation, it is worth noting that neither the actual income tax, where we are, nor a prepaid consumption tax, where we are heading, would.[174]

C. *Progressivity*

The key insight of the new understanding of tax is that, in devising a just and practicable comprehensive tax system, the commitment to progressivity in individuated tax burdens ought to come first and be foundational. It is not sufficient to meet this commitment through the choice of base, alone. We do not have and have never had an income tax, and largely for the reason that we do not want one — we do not want the double taxation of all savings. Within the tax system, progressive rates have become the primary engine of effecting fairness.[175] The next question is to what should we apply these rates: a question that can be restated in the temporal terms used above, namely as asking when, in a taxpayer's flow of funds, it is fair and appropriate to levy progressive taxes. Under progressive rates, the traditional view of the mapping between income and consumption taxes, and between types of consumption taxes, is wrong. Each tax has very different properties. These properties can be understood as affecting capital smoothing and shifting transactions differently: as, that is, differentially implementing the yield to capital and ordinary-savings norms.

The principal mechanism for implementing progressivity in the income tax — for meeting the vertical equity norm — is its system of

174. *See infra* Part V for a critique of the current "income" tax.

175. Another idea for effecting justice in social systems is to abandon progressivity in tax, per se, and to obtain redistribution via transfers or expenditures. *See* Bird & Zolt, *supra* note 51 (commenting on this strategy for the developing world).

progressive marginal rates. Such progressive marginal rates work like a ladder. As one ascends into the higher-rate brackets or rungs of the ladder, she does not lose the benefit of the lower-rate brackets or rungs. Consider the very basic marginal tax rate schedule set out in Table 2. The first $10,000 of income (or whatever is being taxed in the base) generates no tax. The next $20,000 — the dollars that take one from $10,000 to $30,000 of total income — are taxed at a 15 percent marginal rate. Thus by the time a taxpayer has made $30,000, she has paid $3,000 (not $4,500) in tax: 0 on her first $10,000, and $3,000, or 15 percent, on her next $20,000. Once one exceeds $30,000, the next dollar is taxed at 30 percent. So a taxpayer making $30,001 is taxed $3000.30 (not $9000.30); the $3,000 paid on her first $30,000, as calculated above, plus $.30 on her last, or marginal, dollar.

TABLE 2: ILLUSTRATIVE MARGINAL TAX RATE SCHEDULE

Income	Marginal Tax Rate
$0 - 10,000	0 percent
$10,001 - 30,000	15 percent
over $30,001	30 percent

Marginal tax rates are important for their marginal incentive effects.[176] Social justice, however, is more concerned about average or (equivalently) effective tax rates: ensuring that the more able to pay, in fact, pay a higher percentage of their wealth in taxes than the less able to pay. Average tax rates are simply the total tax paid divided by the total income (or alternative base). In our running example, using Table 2, the taxpayer who has made $30,000 and paid $3,000 in tax — while she stands on the brink of entering the 30 percent marginal rate bracket — is paying 10 percent taxes on average. (It is a common mistake to confuse average and marginal tax rates; this explains the emphasis on "not" numbers in the parentheses in the prior paragraph). While progressive marginal rates necessarily lead to progressive average tax burdens, the converse does not hold: we can achieve progressivity in effective burdens with a combination of lump sum grants and declining marginal tax rates, a key insight of Mirrlees and the optimal income tax literature.[177]

176. MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 78-81; Bankman & Griffith, *Social Welfare*, *supra* note 12.

177. *See, e.g.*, Mirrlees, *supra* note 12; Berliant & Rothstein, *supra* note 12.

FIGURE 5

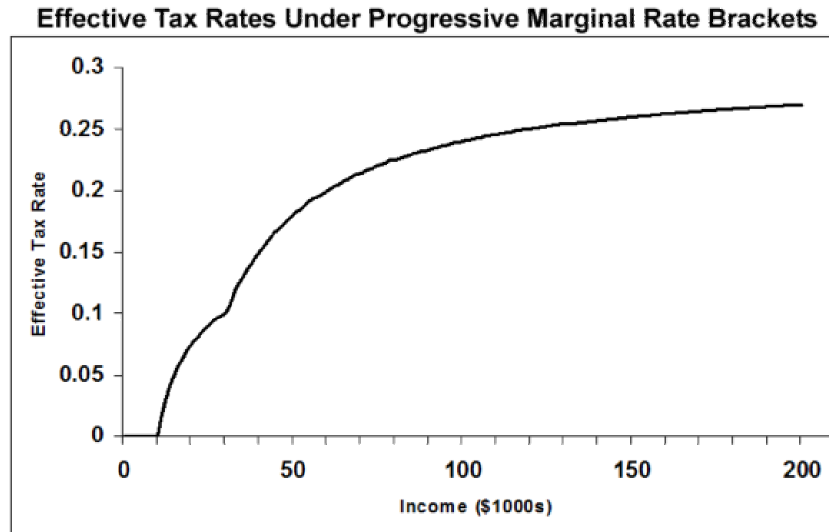
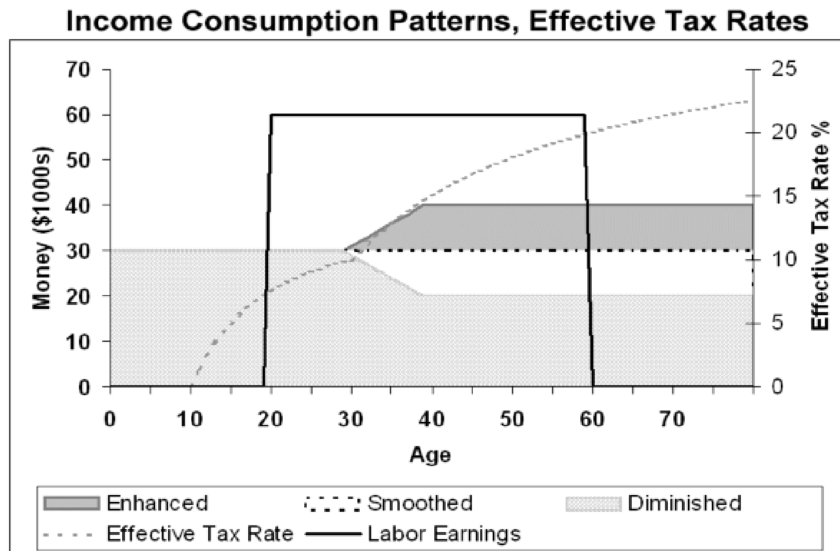


Figure 5 translates the simplified marginal rate schedule of Table 2 into effective tax rates. Having a progressive tax system means that such a figure, plotting income (or any alternative tax base) along the X-axis against effective tax rates on the Y-axis, will show a constant increase. That is, higher levels of income, or labor wages, or consumption — respectively in each of the three taxes we are considering — will be taxed higher, on average, asymptotically approaching the highest marginal tax rate.[178]

178. That is, as *x* (income) approaches infinity, a taxpayer gets closer to paying the highest marginal rate, here 30%, on *average*.

FIGURE 6



The central argument of this Article can be seen by superimposing Figures 1-4 onto Figure 5, as Figure 6 does. I do not mean to suggest that tax rates would or could be the same under the three tax systems. It can be hard, for macroeconomic reasons, to compare rates across different taxes.[179] Rates might differ under an income, prepaid, or postpaid consumption tax in order to raise the same amount of revenue; this depends on the breadth of the base, and so on, and is a complicated empirical project. Further, and very importantly, as a normative matter, the nature of the case for progression changes with the nature of the tax base; this is another central insight of the new understanding of tax obscured by the traditional view. Once again, we can think differently about taxing uses than sources. But fortunately it is not necessary to make the rates comparable — to "score" a revenue neutral result — in order to see the main points. Figure 6 simply illustrates how capital smoothing and shifting transactions are taxed within each tax system, against a backdrop of not engaging in them.

A prepaid consumption tax taxes along the solid labor wage line and ignores all variations. Under the tax rates of Table 2, this means that the taxpayer in the running example will pay $12,000 per year for the 40 years in which she works, a 20 percent average rate over her

179. Rates might also change over time on account of the greater efficiency of a new tax, a point David Bradford impressed on me. *See* David F. Bradford, *Transition to and Tax Rate Flexibility in a Cash-Flow Type Tax*, *in* 12 TAX POLICY AND THE ECONOMY 151-72 (James Poterba, ed., 1998). This complicates but does not fundamentally alter the analysis.

lifetime ($480,000 out of $2.4 million).[180] Such a tax ignores all shifting, upwards or downwards, and smoothing. The "spikier" the inflows line — the greater the variance in the realization of labor market returns — the higher the lifetime tax. Any enhancements due to success in the capital markets or someone else's beneficence get ignored.

An ideal income tax would also tax on the basis of this labor market earnings line, and would add a further tax — Mill's second — for any positive returns to the savings needed to effect a constant lifestyle going forward.[181] In general, a progressive income tax burdens both shifting and smoothing capital transactions. Compare a taxpayer under an income tax who in fact earns and spends $30,000 a year, with one who earns $60,000 over 40 years and spreads it across 80. The latter, smoothing taxpayer is hit hard by progressive rates: she pays $480,000, just as under the prepaid consumption tax example of the prior paragraph, a 20 percent effective rate. The naturally-smoothed taxpayer in contrast pays $240,000 in lifetime taxes — $3,000 a year for 80 years; her labor market earnings generate a 10 percent effective tax rate. The smoother is also hurt by the double taxation of savings needed to effect her backward smoothing: any positive interest here will bear Mill's double tax. She is also harmed by the tax treatment of debt in effectuating her forward or anticipatory smoothing, given the limitation on the deductibility of interest.[182] And, of course, any enhancements above her labor market earnings will be taxed, while diminutions may or may not be relevant.

A postpaid consumption tax, in contrast, applies to the actual consumption line. The perfect smoother, living at $30,000 a year, would pay $3,000 a year, a 10 percent rate across her entire life ($240,000 out of $2.4 million), just like the naturally smoothed taxpayer. The enhanced consumption profile would pay more: under progressive tax rates, a postpaid consumption tax does get at the yield to capital, as well as beneficent transfers, when these are used to upward shift. The diminished consumer would pay less. But if the diminished consumption was due to the transfer of resources to another taxpayer, the tax will lie in wait, to fall on this heir's enhanced consumption.

We can cash these observations out with some simple, paradigmatic examples. Imagine three putative taxpayers: Steady Earner, who earns $50,000 annually for all relevant periods; Lumpy Earner, who earns $100,000 annually for half of the relevant period,

180. Once more, she pays 0 on her first $10,000; $3,000, or 15%, on her next $20,000; and $9,000, or 30% on her "last" $30,000.

181. This second tax is not reflected in the picture because of the simplifying assumption of a 0% rate of return.

182. *See* I.R.C. § 163(a), (d), (h) (2004).

borrowing and saving, as in the example above, to consume $50,000 annually throughout the period; and Trust Fund Baby, who lives off $50,000 of investments returns from an ancestral trust.[183] An ideal progressive income tax falls hardest on Lumpy Earner, treating Trust Fund Baby and Steady Earner alike. A progressive prepaid consumption or wage tax falls hardest on Lumpy Earner and altogether ignores Trust Fund Baby.[184] (The actual income tax we have treats Trust Fund Baby quite well, too, as Part V illustrates). A progressive postpaid consumption tax treats all three taxpayers alike.

In sum, an income tax double taxes both shifting and smoothing capital transactions; a prepaid consumption tax ignores both; and a postpaid consumption tax accommodates smoothing but differentiates between upward (which lead to higher taxes) and downward (which lead to lower taxes) shifting transactions. By ignoring smoothing, progressive income and prepaid taxes make the time path of earnings economically significant. By accommodating smoothing, a postpaid consumption tax does not.

D. *Debt, Again*

Debt, or borrowing, is critical to smoothing, and also to the distinctions among the three types of ideal taxes.[185] Positive savings allow an individual to defer the enjoyment of labor-market earnings, to push them backward in time. Borrowing, as negative savings, serves a symmetric function: it allows one to shift forward her labor market earnings, to consume before earning, as Figure 2 and subsequent figures had shown. An income tax is inconsistent in its treatment of debt and savings, because it "double taxes" the latter but not the former, although the technical analysis depends on the deductibility of interest.[186] Both prepaid and postpaid consumption taxes are consistent: the former ignores all savings, and the latter deducts all savings. This leads under a postpaid consumption tax to the inclusion of debt as a taxable inflow (as negative savings) and a deduction for all repayments of principal and interest.

183. $50,000 represents a 5% annual yield on a $1,000,000 corpus, a sum easily transferred tax-free under today's wealth transfer system. *See infra* Part VI.B.

184. Some one might have once paid some tax on Trust Fund Baby's fortune, of course, but not necessarily. *See* Boris I. Bittker, *Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?*, 28 NAT'L TAX J. 416 (1975), *reprinted in* COLLECTED LEGAL ESSAYS 547 (1989) (a charming tale of benefiting from the income tax's incentives . . . before the tax was even enacted).

185. *See* Adam Hime, Note, *Getting Schooled by the Hybrid-based Tax: Equity and Efficiency in the Federal Tax Treatment of Debt-financed Post-Secondary Educational Expenditures*, 77 S. CAL. L. REV. 871, 889-91 (2004).

186. *See generally* Auerbach, *supra* note 42.

All this takes on significance when progressive rates are in play. By ignoring both the initial incurring of debt and its subsequent repayment, the prepaid consumption and income taxes each penalize those whose uneven pattern of labor-market earnings require them to borrow in their youth to finance their lifestyles. An important class of taxpayers in this situation is, of course, students. The postpaid consumption tax solves this problem by including debt as a taxable inflow and allowing a systematic deduction for all repayments of principal and interest; it allows a taxpayer to smooth forward in time, just as retirement savings provisions under the so-called income tax allow her to smooth backward.

Students often recoil at the notion that the proceeds of their borrowing will be included in their tax base, as would be the case under a consistent postpaid consumption tax. But such an inclusion, logically followed by a deduction in the year of repayment, in fact effectuates the ordinary-savings norm going forward; it is traditional IRA or qualified-pension-plan treatment in reverse. Given progressive rates, the difference is significant. In the running example, the student borrower will pay a 10 percent effective tax on her loans under a postpaid tax, while she would pay 20 percent under an income or a prepaid consumption tax model to generate the after-tax dollars to pay off those loans. In practice, today, law students must earn twice their student-loan balances in order to pay off their debts, because they must also pay Uncle Sam out of the earnings — first.

Within the new understanding of tax, borrowing, or negative savings, has an important symmetry with positive savings. Both typically effectuate the ordinary-savings norm. Just as savings allow the wage earner to shift some of her labor earnings backward in time, to finance her retirement, so borrowing allows her to shift her labor market earnings forward in time, to finance her youth and education.[187] Progressive income and prepaid consumption taxes burden these shifts — they disfavor smoothing transactions — because the tax falls, and hence the appropriate level of progressivity is set, at the moment of labor market earnings, which is arbitrary and uneven. Income taxes further burden smoothing transactions by the double taxation of savings used to effect them. A postpaid consumption tax, in contrast, accommodates smoothing because the moment of ultimate private use is the moment when decisions about rate progression are set. On the other hand, savings that finance enhanced lifestyles or debt that enables taxpayers to live "beyond their means" are disfavored by the ordinary operation of the tax: the former phenomenon effecting the yield-to-capital norm, the latter creating a "paternalistic push" to

187. Note that intergenerational smoothing allows family annuities markets to effect this result.

even out lifestyles within the structure of a progressive postpaid tax, and to use debt wisely.

E. *Vickrey's Cumulative Lifetime Averaging, Compared*

A consistent postpaid consumption tax is not the only means of effectuating smoothing or averaging to avoid the problem of the uneven time-path of labor market (and other) earnings. Vickrey proposed a mechanism of smoothing by accounting conventions, a "cumulative lifetime averaging" technique that helped to put tax burdens on what Vickrey took to be a normatively appropriate lifetime basis.[188] *Blueprints for Basic Tax Reform* also contained some discussion of the idea,[189] and the Internal Revenue Code contained limited income averaging provisions for a number of years.[190] Despite Vickrey's frequent protestations to the contrary, the idea is complicated in practice. It entails choosing a certain period for smoothing, adding up cumulative income (or consumption) within the period, subtracting previously taxed income (or consumption) and then applying a rate structure, which could lead to negative taxes (refunds) as well as positive taxes (payments) in the immediate period of the return, depending on how this period fit with the average. Human events such as marriage, divorce, and death were subjects of some concern, and so on. A consistent progressive postpaid consumption tax without cumulative smoothing is far easier to implement.

Let us set aside, however, these practical or second-best concerns for a moment. For present purposes, imagine that Vickrey's proposal could be implemented seamlessly, by summing up lifetime income, dividing by the years of the taxpayer's life, and basing a payment (annual or lump sum) on the average annual income level. So stated, there are two issues at the level of first-best, or ideal, theory to differentiate the proposal I am pressing, for a consistent, progressive postpaid consumption tax, from Vickrey's proposal for cumulative averaging — though we importantly share the end of effecting meaningful progression in the allocation of tax burdens, and hence have much more in common than sets us apart.

To see the two issues, note that Vickrey's plan is set in the context of an income tax, where the problem of uneven labor earnings is made more acute by arbitrary patterns of financial capital realizations as

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188. *See* Vickrey, *supra* note 102.

189. *See* BRADFORD ET AL., *supra* note 8, at 74-75. I thank David Bradford and Jim Hines for a discussion of this and related points.

190. I.R.C. §§ 1301-05 (1982) (repealed 1986). For a discussion of how these (complex) provisions operated, *see* BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (1981) ¶ 111.3.13, pp. 111-70 to 111-75.

well. Taxing earnings consistently throughout a lifetime, however, effectuates a smoothing, by design, such that an income tax with cumulative averaging begins to resemble a consistent postpaid consumption tax. The simplest way to see this point is that if a taxpayer balances her books within her lifetime — neither leaving nor receiving any net beneficent transfer — then lifetime income equals lifetime consumption (consider the Haig-Simons definition, Equation [1], across a lifetime, with no net savings, so that income = consumption). So there is no net difference, in the aggregate amounts taxed, between a Vickrey-income tax and a postpaid consumption tax for those who do not save beyond their lifetimes. This background points out the two theoretical differences between Vickrey's cumulative averaged income tax and a consistent postpaid consumption tax.

First, those who do engage in intergenerational wealth transmissions — those whose available resources exceed their consumption within their own lifetimes — will see their taxes, that is, the taxes paid within their generation, go down under a postpaid consumption tax compared to Vickrey's tax. Once again, it is not, however, the case that total taxes, across generations, will go down by the transmission under the postpaid model; this depends on whether the intergenerational shift is upwards or downwards, as noted above. The multigenerational comparison between Vickrey's income averaging and a postpaid consumption tax also depends on the rate structure of each. The choice — still in first-best theory — turns on what we think of intergenerational smoothing activities. Here reasonable minds can differ. In theory, one could certainly argue that an incentive to transfer wealth across generations in a smoothing fashion — or, equivalently, the absence of an incentive to consume excessively in the present generation — is a good thing.

This is so for several reasons. One, intergenerational smoothing implements a familial annuities market that need not be disfavored over third-party mechanisms (consider Figure 3, with its overlapping generations). Transfers from grandparents to parents and parents to children stand in lieu of each generation's annuitizing for itself, forward and backward within its own lifetime. Two, transfers to otherwise lesser-consuming individuals are, in a straightforward application of utilitarian theory, welfare-enhancing. Nor are these inducements somehow illiberal — after all, an incentive for the first generation to consume everything and die broke is problematic, too. If the intergenerational transfers turn out to allow for greater consumption at the second and lower generations, the mechanism of progressivity under the postpaid consumption tax will burden them. A consistent progressive income tax with Vickrey averaging, in contrast, will double-tax the transfers — in the first generation at a high level because of the potential to consume, in the second generation as a

source of use. A single tax, set at a level individuated by the user, seems preferable. Once again, a consistent progressive postpaid consumption tax, applied across generations, implements both the ordinary-savings and yield-to-capital norms, simultaneously, by design. These norms are as compelling between as within generations.

Whereas this first difference turns on our thoughts about intergenerational savings, the second difference between a consistent postpaid consumption tax and Vickrey's cumulatively averaged income tax relates to the taxation of consumption itself, within a generation. A move to a consistent postpaid consumption tax avoids the problem of having the morally arbitrary pattern of inflows dictate the level of progressivity. But it only does so if the taxpayer actually does smooth his consumption. If Lumpy Earner makes and *spends* $100,000 a year, he foregoes the benefits of smoothing under a postpaid consumption tax. Vickrey might well ask here why the actual pattern of consumption should matter, as opposed to an average lifetime measure that would reflect the vertical equities of the wider view without the happenstance of uneven earnings *or* spending patterns.[191] In other words, even if Vickrey or a disciple should concede the first point, that consumption and not income is the right thing to cumulatively average, why should we not do the averaging within a consumption tax design? Why, that is, should the government differentiate between someone who spends an even $30,000 every year and someone who alternates years of $40,000 in spending with years of $20,000 in spending? The Vickrey lifetime averaging mechanism, applied to a consistent consumption tax base, would alleviate this problem.

Now as with the first point, reasonable minds can certainly differ. There is nothing in the new understanding of tax that would or should reject a cumulatively averaged consumption tax out of hand. Far from it: This is a serious idea, and an attractive means to a meaningful progressivity in tax, where the new understanding of tax aims. Once again, however, I suspect that the practical answers are decisive: Cumulative averaging is too complex, and its benefits over a nonaveraged postpaid consumption tax are too minor, to mandate it. But we can also once again proffer several arguments suggesting that an averaging mechanism is not needed, and that the relatively simple, unadjusted, progressive postpaid consumption tax model, applied across and within generations is, indeed, an attractive ideal.

First, it is important to note that a taxpayer's smoothing need not be precise to effectuate lifetime tax minimization, on account of the marginal rate bracket mechanism. The very width of the rate brackets,

191. I thank Jim Hines and David Weisbach for their persistence in pressing these points on me.

and the slope of their graduation, can be set to mitigate the effect. Consider again the marginal rate structure set out in Table 2. A considerable part of the virtue of a consistent postpaid consumption tax is that there can continue to be rate brackets at higher levels of consumption because the disincentive effects do not fall on work effort per se.[192] Suppose, for example, that there was a 40% bracket extending from $100,000 to $200,000. A taxpayer who spent $120,000 in one year and $180,000 in the next would bear no burden on account of not consuming an even $150,000 in each year.[193]

Second, capital market mechanisms can rather easily and effectively deal with many consumption-smoothing problems, such as consumer durables, an issue that haunted Andrews and *Blueprints*.[194] The problem is that a taxpayer who makes a large purchase in one year, say of a house or a car, will show a certain "lumpiness" in her consumption, which might indeed trigger higher taxes under a consistently progressive postpaid consumption tax. But capital transactions, such as leasing or buying over time, can fairly readily solve these problems — in a manner that is not always possible with self-help labor market averaging.[195] Rather than spending $20,000 on a car in a single year, for example, a five-year payment plan will effectuate a $4,000 annual charge. And housing, which is a complex item to tax under any broad-based tax, because of its mixture of consumption and savings elements, can be handled in several different ways to avoid the specifically lumpy consumption problem.[196]

192. *See* FRANK, *supra* note 113, at 228-31; Edward J. McCaffery, *The Tyranny of Money*, 98 MICH. L. REV. 2126, 2129-30 (2000) [hereinafter McCaffery, *Tyranny*] (reviewing FRANK, *supra* note 113). This point also relates back to the first argument against Vickrey's position, specifically his use of an income tax base as default. A well-designed tax system, I am arguing, should allow an "escape valve" for excessive lifetime earnings — it should allow and perhaps even encourage the wealthy to continue to work and save, hoping that they *not* spend their "surplus" funds on themselves. A tax system that taxes spent and unspent resources does not do this; it disincentivizes work effort by those who have already funded their own generation's needs and wants.

193. Even a taxpayer who slightly straddles the line will not pay a grave price, on account of the slope of the marginal rate brackets. For example, a taxpayer who consumes $230,000 one year (in the 50% bracket, say), and $170,000 the next, would pay an extra $3,000 (10% of $30,000), or 1.5% of income, for the imprecision. If the brackets increased in 5% intervals, the "problem" would be even smaller. I thank Reed Shuldiner for the example.

194. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1150, 1155-57; BRADFORD ET AL., *supra* note 8, at 81, 108-09, 117.

195. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 134-36. Reed Shuldiner has pressed me on this need for advice. But, of course, taxpayers today need much advice on shifting labor and capital market returns around in time. Consumption smoothing, in contrast, seems more natural and largely within a taxpayer's control. *See* SMITH, *supra* note 54, at 778.

196. *See* BRADFORD ET AL., *supra* note 8, at 78 (ignoring the imputed income of home-ownership "for the sake of simplification"); MCCAFFERY, FAIR NOT FLAT, *supra* note 2.

Third, once the modifications suggested by the first two points (wide rate brackets, gradual progressivity, and capital market transactions) are understood, a strong argument exists that the pattern of household consumption is not morally arbitrary. Determining the appropriate spending level is importantly a matter of choice, and one that affects the wider body politic.[197]

Fourth, and related, there are paternalistic reasons to try to get individuals actually to smooth their consumption — certainly a good deal of current American socio-economic policies are designed with this goal in mind, not the least being the forced retirement savings effected by the social security system.[198] Vickrey, as a classical economist, was drawn to the neutrality of the income-averaging scheme; it does not matter whether a taxpayer does smooth because all taxpayers with equal lifetime material resources, measured in constant dollar terms, pay the same lifetime tax, irrespective of how they choose to spend their wealth. On the other hand, ordinary moral intuitions may question this proposition. It is prudent and good to live within one's means, to borrow sensibly in youth and to save responsibly in middle age.

Once again, to be clear and fair, these various arguments against Vickrey's very clever cumulative lifetime averaging proposal, at least when set in the context of a consumption tax (that is, after the first point, on the income-versus-consumption difference, is set aside) may be more a matter of making a virtue out of a near-necessity, for Vickrey's proposal is complicated, and would make annual tax reporting more burdensome and counterintuitive, while a consistent postpaid consumption tax is comparatively straightforward. Still, a compelling case can be made that what the progressive postpaid consumption tax does simply, by design, is also the right thing to do. We should celebrate the fortuity.

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197. McCaffery, *The Right to Waste?*, *supra* note 24; McCaffery, *Uneasy Case*, *supra* note 165; Smith, *supra* note 54, at 778. It is curious that some argue against this moralism, while advocating, explicitly or implicitly, for progressive income tax rates. It is difficult to see why the harm from unequal earnings is greater than the harm from unequal spending, especially when a tax system can constrain what can be done with the earnings. The problem of the accumulated capital itself is, of course, a different matter, which I have addressed elsewhere and note again below, *infra* Part VII.B.4. *See* McCaffery, *Being the Best*, *supra* note 15; Edward J. McCaffery, *The Political Liberal Case Against the Estate Tax*, 23 PHIL. & PUB. AFF. 281 (1994) [hereinafter McCaffery, *Political Liberal Case*]; *but see* Rakowski, *supra* note 15; Deborah Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99 (2003).

198. Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275 (1991).

V. In Practice: The Mess We've Made, Part One — The Income Tax

We now leave the comfortable towers of ideal theory, and descend into the devilish details of practice. The key insight of Andrews's 1974 article was that the income tax was badly deficient when it came to getting at the savings component of the right-hand side of the Haig-Simons definition of income,

Income = Consumption + Savings. [1][199]

Andrews argued for a more consistent treatment of savings, in the form of its systematic exclusion, on essentially second-best grounds: even if we should tax all savings, as a matter of ideal theory, the fact that we do so only erratically, as a practical matter, suggests that we abandon the attempt in the name of consistency and fairness. Andrews ran into trouble when he tried to superimpose a possible first-best justification for the logically concomitant shift to a consumption tax.[200] But there was no denying the facts of the matter: the so-called income tax was erratic in getting at savings, at best. Under the traditional understanding of tax, any failure to get at savings results in a consumption tax. Thus scholars and commentators, beginning with Andrews himself, began calling the existing tax a "hybrid" one, a mix of income and consumption tax elements.[201]

The new understanding of tax shows that the conflation of prepaid and postpaid consumption tax models in the traditional view has limited the understanding of the status quo. Once we have come to understand that prepaid and postpaid consumption taxes are not equivalent under progressive tax rates, we want to know, specifically, what kind of consumption tax we have and should have, in whole or in part. The new understanding opens the door to a more nuanced critique of the present tax.

Much of tax policy since the 1970s, and especially in the last few years, has involved a steady drift towards a specifically prepaid consumption tax. Tax falls fully on labor earnings as they come into

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199. Professor Andrews wrote:

> [T]he ultimate policy choice to be made is between achievable ends, not abstract ideals. Most of my prior article [Andrews, *Personal Income Tax*, *supra* note 8] was designed to show that the most intractable difficulties in the existing income tax arise from the virtual impossibility of achieving a satisfactory reflection of real accumulation in a practical income tax base, and that these difficulties could be readily avoided by pursuing the goal of consumption instead of accretion.

See Andrews, *Reply to Professor Warren*, *supra* note 16, at 947.

200. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1167-68.

201. The phrase was first used in Andrews, *Personal Income Tax*, *supra* note 8, at 1117. *See also* Auerbach, *supra* note 42; McCaffery, *Hybrid*, *supra* note 23.

households, but any subsequent taxation on accumulated financial capital or its yield is easily avoided. Taxes on the yield to capital have become voluntary in important ways. This is a fact, and one we ought to be confronting far more forcefully in our practical as well as normative tax policy.[202] Over time, the real fault line in practical income tax policy has become to preserve the tax as an effective wage tax, while making sure that the gaps on the capital side — holes that the system seemingly lacks the will, the way, or both, to fill up — do not spill over to engulf the labor side. The Tax Reform Act of 1986, considered at some length below, is the grand example of this phenomenon. We are slowly, seemingly inexorably, drifting towards a prepaid consumption or wage tax. We will wake up soon with a flat tax, seemingly against our very own wishes.[203]

The traditional view of tax continues to argue for an "income" tax as if we have had, have now, or ever will have one, in opposition to the movement towards a prepaid consumption tax. But the real choice — the only choice — is what kind of consumption tax to have. This Part aims to drive this point home, loud and clear. It canvasses what is wrong with the actual income tax as a practical matter. There are both structural and seemingly ad hoc deviations from the income tax's commitment to taxing savings. Ironically, it is the ad hoc deviations that point the way towards a better future for tax; the structural gaps, nightmares of tax past, haunt its present. We start with these deficiencies.

A. *Structural Gaps*

The problems with the "income" tax begin — and, to some considerable extent, end — with *Eisner v. Macomber*,[204] a 1920 decision of the United States Supreme Court that dealt with the timing of taxation, although the Court itself and the parties before it were slow to see the true stakes involved.[205]

Mrs. Macomber, a shareholder in Standard Oil, had received a "stock on stock" dividend. To simplify the actual math of the matter, assume that this was a one-for-one stock "split." In other words, Mrs. Macomber, who one day held 100 shares of stock, found herself

202. *See* Edward J. McCaffery, *A Voluntary Tax? Revisited,* Proceedings*, 93rd Annual Conference of the National Tax Association*, *2000*, 268 (2001) [hereinafter McCaffery, *A Voluntary Tax?*]; *see also* ROBERT T. KIYOSAKI & SHARON L. LECHTER, RICH DAD, POOR DAD (1997).

203. Norquist, president of Americans for Tax Reform, notes that piecemeal tax measures are bringing us ever closer to a flat tax. *See* Norquist, *supra* note 109.

204. 252 U.S. 189 (1920).

205. For additional detail, see Majorie E. Kornhauser, *The Story of* Macomber: *The Continuing Legacy of Realization*, *in* TAX STORIES 53 (Paul L. Caron ed., 2003).

owning 200 shares the next day. Since every other shareholder received the same split, the occasion was not itself an accession to wealth. The number of outstanding shares of stock had simply doubled across the board and — minor frictions aside — the value of each share of stock, necessarily, fell by half. If each of Mrs. Macomber's 100 shares had been worth $10 each before the split, she would have had 200 shares worth $5 each after it. Mrs. Macomber's total value of Standard Oil stock holdings would be $1,000 before and after the paper transaction.

The much-watched case made it all the way to the Supreme Court. It was clear that the government was having a hard time articulating its reasoning for imposing a tax on the unlucky Mrs. Macomber, and the case actually went through two hearings before the Court.[206] Finally, the government got to the crux of the matter. Conceding that the actual stock dividend was not an accession to wealth, and that it was not the "new" shares of stock, per se, that it was attempting to tax, the government argued instead that the "income" had come from the antecedent rise in value of Mrs. Macomber's shareholdings, which the government could have taxed whenever it chose to; the moment of the stock on stock dividend was merely a "convenient" time to do so. This argument sounds in Haig-Simons income. The words Simons actually used to describe the savings component of income were, after all, "the change in value of the store of property rights between the beginning and end of the period in question."[207] Suppose Mrs. Macomber had purchased the stock some years ago for $200. It was now worth $1,000. Mrs. Macomber had "income" of $800 in the Haig-Simons sense — at some time — because of the "change in value of the store of her property rights."

Unfortunately for the government, by the time it got around to making its argument, the Justices rejected all of its claims by a five-to-four count. Mrs. Macomber would have no taxable income until and unless she "realized" the gain in her stock, as by selling it. The "realization requirement" announced in *Macomber* is simple enough to understand. Its logic is compelling, even: Why should taxpayers pay a tax without a transaction generating the cash with which to pay it? Why not wait until a sale or other disposition to get at the gain?[208] The answers given to these rhetorical questions in the context of an income tax — that it was indeed alright to wait and see, and pay later — are devastating. The time value of money suggests that a tax paid later is

206. *Macomber* was first argued before the Court on April 16, 1919, restored to docket for reargument May 19, 1919, and reargued October 17 and 20, 1919. The decision was handed down March 8, 1920.

207. *See* Simons, *supra* note 29, at 50.

208. *See* I.R.C. § 1001(a) (2004).

better, to a taxpayer, than the same tax paid sooner.[209] Worse yet, the confluence of the realization requirement with two other structural features of the income tax combine to make any tax on the yield to capital, however and whenever used, voluntary. *Macomber* marked the end of the income tax, still in its first decade of existence; as Andrews later put the matter, the realization requirement was "the Achilles' heel" of the income tax.[210] Recall that, with Achilles himself, the seemingly minor flaw proved fatal.

1. *Tax Planning 101*

The realization requirement has a simple, intuitive appeal: indeed, a postpaid consumption tax operates much along a realization model, deferring the time of tax until capital is converted into cash for consumption.[211] The problem is that the realization doctrine given birth by *Macomber* did not spring into existence under a postpaid consumption tax. It was engrafted onto a theoretical income tax. This is a fatal flaw.

Recall the income tax's principled nontaxation of debt. Combined with *Macomber's* realization requirement, this means that one can borrow — directly or indirectly using appreciated assets like Mrs. Macomber's stock as collateral — and consume, tax-free. Consumption financed by debt backed by capital assets falls out of the tax base for an income-with-realization tax. Far from simply missing an element of savings, or the yield to capital, *the actual income tax fails to reach the personal spending of the propertied classes*. In such a case, there can in fact be no savings: if the borrowing to consume precisely offsets the rise in value of the assets — as it will in the numeric example set out below — there is no net accretion to wealth. There is simply consumption without taxation. The perverse result derives from the conjunction of two timing rules under the flawed income tax: first, the "wait until realization" doctrine of *Macomber*, and, second, the "wait until debt is repaid" doctrine inherent in the Haig-Simons definition of income. By using unrealized assets to help obtain debt financing now,[212] the savvy taxpayer gets to have her cake and eat it, tax-free, too.

209. CHIRELSTEIN, *supra* note 56, at 2-3; Andrews, *Personal Income Tax*, *supra* note 8, at 1123-24; *see generally* Halperin, *supra* note 73.

210. *See* William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S, at 278, 280 (Charls E. Walker & Mark A. Bloomfield eds., 1983).

211. For an interesting discussion of the realization requirement, see Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75 (2003).

212. Note that the result does not turn on any literal pledging of assets as security, though this might lead to more favorable credit terms.

Eventually, it would seem, things must work out and the books become balanced: the debt must be repaid, with nondeductible or after-tax dollars from fresh labor-market earnings or realized capital transactions, and a tax will be paid. Later is better than sooner, so the taxpayer has still gained an advantage from holding and borrowing, but at least a tax will get paid eventually. Yet "later" may never come when we add a third doctrinal feature of the status quo, not unrelated to the *Macomber* story: the "stepped-up basis" for assets acquired on death.[213] This statutory doctrine provides that assets acquired from a decedent shall have a taxable "basis" equal to the fair market value of the property on date of death.[214] This means that an heir, who acquires the property itself tax-free,[215] can also sell it the next day, tax-free.[216]

The stepped-up basis rule structurally follows from the realization requirement. *Macomber* alone gave taxpayers an incentive to acquire the kind of assets that rise in value without producing taxable cash, in the form of interests and dividends: Such disfavored assets walk head-on into Mill's second tax, whereas the realization requirement gives a way to defer the government's second bite at the apple for non-cash-generating property. The realization requirement destroys the source neutrality of an ideal income tax. Assets that go up in value via price appreciation alone, such as growth stocks, land, art, and so on, have an advantage over simple bonds and bank accounts that produce readily observable cash flows to their holders.[217] In the wake of *Macomber*, the rich and well advised could be expected to acquire capital assets; the financial markets could be expected to generate such assets. They did. Further, *Macomber* gave wealthy taxpayers an incentive to hold onto their "winners," even as they could sell their "losers."[218] The ability to borrow tax-free meant that holding onto appreciated assets need not entail any personal sacrifice in consumptive lifestyle. And so it came to pass, predictably enough, that the economy became full of assets with "built-in gain;" that is, assets that had a tax "basis" equal to their initial cost, but a fair market value far in excess of this historic

213. *See* I.R.C. § 1014 (2004).

214. *See id.* For a definition of "basis," see MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 30 ("*Basis* means, in essence, after-tax dollars."). I prefer this definition to the often-used definition of "cost" in part because of the stepped-up basis rule.

215. I.R.C. § 102 (2004).

216. The stepped-up basis under I.R.C. § 1014 (2004) means that the gain calculated under I.R.C. § 1001 (2004) will be zero.

217. *See* KIYOSAKI & LECHTER, *supra* note 202. The holders of appreciating assets that do not produce cash flows can simply borrow against the increase in value of such assets, thereby gaining access to cash without the tax liability of assets that generate realized proceeds.

218. The tax benefits of this strategy are subject to capital loss offset rules, discussed *infra* Part V.B.2.

figure. Just like Mrs. Macomber's stock, in the numbers given above, had a basis of $200 and a fair market value of $1,000.

This built-in gain had to be preserved in the case of gifts among the living, or any taxation on capital assets would be trivially avoided. Mrs. Macomber could simply give her stock to her husband or child, who could sell it, tax-free, and perhaps later gift the cash back to her. Hence the law instituted a "carryover" basis regime for gifts, preserving the donor's basis in the donee's hands.[219] But what of assets passed on after death? Heirs complained that it was unfair to saddle them with the inherent tax liability; it was also a practical nightmare to figure out the deceased's basis in the assets. The tax system compromised by putting in place a separate gift and estate tax to get at the net wealth of the truly rich decedents, and allowing everyone to acquire assets from a decedent with a basis equal to their then fair market value — the stepped-up basis rule.[220]

As with the realization requirement, the stepped-up basis rule — for those who can understand it at all — makes a certain sense, in isolation. Yet when put together with the realization requirement and the nontaxation of debt, one has all that she needs to understand "Tax Planning 101." This is simple tax planning doctrine that tax students can learn on the first day of a course in basic federal income taxation — doctrine that underscores how easy it is for those with stocks of financial capital to avoid all federal taxation.[221] Tax Planning 101 is elegantly simple:

- Buy,
- Borrow,
- Die.

That is it. By buying capital assets that appreciate without producing taxable dividends; selling one's losers and holding one's winners; borrowing to finance present consumption; and continuing the game straight on to death, the rich and well advised can avoid all federal taxes. Tax Planning 101, as just set out, avoids income tax to the spender and to her heirs. It avoids the increasingly important social security or payroll tax system, as discussed in the next Part below, for its wealthy practitioners by the simple expedient of their never actually working. Tax Planning 101 avoids the estate tax because that is a net tax levied on assets minus liabilities held at death — but if Tax

219. I.R.C. § 1015 (2004); *see also* Taft v. Bowers, 278 U.S. 470 (1929) (upholding carryover basis for gifts).

220. *See* I.R.C. § 1014 (2004). Joseph Dodge and Jay Soled have suggested that taxpayers may not even be waiting until death to avoid gain legally. Instead they seem to be inflating the basis of assets sold during life, knowingly or unknowingly cheating on their taxes. *See* Joseph M. Dodge & Jay A. Soled, *Inflated Basis and the Quarter-Trillion Dollar Revenue Question*, 106 TAX NOTES 453 (2005).

221. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 32-33.

Planning 101 is taken to its limits, there is no net estate. Tax Planning 101 means no taxes, notwithstanding a comfortable lifestyle for those with the assets in hand to play it.

2. *An Example*

To illustrate Tax Planning 101, consider the curious case of Artful Dodger.[222] Imagine that Dodger somehow has $1,000,000 after taxes. How he got it does not really matter, although it is worth noting that he could have gotten it tax-free from his parents.[223] With this stock of cash, Dodger buys assets. Not just any assets, but the kinds of assets that rise in value without producing taxable cash dividends: growth stocks, say, or land, art, sports franchises even. Dodger sells any assets that go down in value, taking tax losses when he can, carrying them forward when he cannot.[224]

Suppose that the general return on investments is 10 percent. Dodger's $1,000,000, prudently invested, rises in value to $1,100,000 after one year. He pays no tax on this "mere appreciation" under *Macomber*. This might appear to be all fine and good, because Dodger is continuing to save, and so should not be taxed under the logic of a consumption tax, and can await taxation under the logic of an income-with-realization-tax. The trouble is, Dodger need not be saving at all. He could be consuming away.

Dodger borrows $100,000. He pays no tax on this because borrowing is not income under the Haig-Simons definition. Dodger can spend away, living as well as a wage earner making $200,000, but subject to a 50 percent combined federal, state, and local income and payroll tax burden. At the end of Year 1, Dodger's net worth is $1,000,000: his $1,100,000 portfolio minus his $100,000 principal debt balance.

Dodger must pay interest on his debt. But he also has his assets, which he has maintained by borrowing.[225] So, in Year 2, the $1,100,000 portfolio goes up by another 10 percent, or $110,000, to a net of

222. This example is borrowed from *id.* at 33-34.

223. *See* I.R.C. § 102 (2004). Of course, his parents would have, at one time, paid tax on the initial labor market earnings, *see* Warren, *supra* note 13, at 934-41, unless they happen to have received these before the initial imposition of the tax. *See* Bittker, *supra* note 184.

224. I.R.C. § 1211 (2004).

225. Suppose, for example, that Dodger has $1 million worth of assets. He can sell the assets, pay the tax now, and spend what is left, say $600,000 with a 40% effective tax. Or Dodger can instead borrow against the asset and consume tax-free. If he borrows $600,000 at a 5% interest rate, he also retains the asset, worth $1 million and appreciating at its own rate. He can buy a "collar" or enter a "stop loss" order should his assets ever fall in value, which would leave him in the same financial position as he would have been in with an initial sale. But if the assets do not fall in value, he wins. The net cost of borrowing is $i - r$, where i is the interest on the debt and r the return on the asset. If r exceeds i, as it typically would, Dodger makes real value on the strategy. He has his cake and is eating it, too, tax-free.

$1,210,000. Dodger promptly borrows this $110,000. He uses $10,000 to pay off the interest on his Year 1 debt, and $100,000 to consume. At the end of the year, his net wealth is $1,000,000: a portfolio of $1,210,000 minus $210,000 in debt.

As long as his portfolio rises by the same amount as the interest on his debt, Dodger never pays tax, always has $100,000 of consumption, and always maintains his $1,000,000 net wealth. If he can borrow less principal than the rise in his portfolio — live at a $50,000 level, say, or, in the case of Bill Gates, a few billion — and if the appreciation in his portfolio exceeds the interest rate on his debt over time, he keeps getting richer. If he needs to diversify his portfolio, not to worry: clever tax lawyers and accountants have devised ways to do just that, such as by various "mixing bowl" transactions, tax-free.[226] Too much risk? Not to worry: various financial instruments, such as "cuffs" and "collars" come to the rescue.[227] Much simpler devices, such as universal life insurance policies, can do the trick as well.[228]

Neither Dodger nor his estate, in this example, will ever pay any gift or estate tax. When Dodger dies, his heirs will inherit his assets income-tax free.[229] They can sell them off for no gain because of the stepped-up basis rule.[230] Then they can pay off Dodger's debts and keep whatever cash is left over. As long as Dodger has borrowed enough to bring his net estate below $1,500,000 or so — actually, below $3.5 million under current law, in 2009, or infinity, in 2010[231] — no estate tax will be due.

This is all, of course, nice work — if you can get it. One can indeed get it — if she has wealth to start — under today's tax laws featuring a nominal income tax.

3. *The Practical Facts of the Matter*

How many rich Americans take Tax Planning 101 to its limits, avoiding all taxes, is an empirical question that is rather hard to

226. For a discussion and explanation of mixing bowl transactions, see Louis S. Freeman et al., *The Partnership Union: Opportunities for Joint Ventures and Divestitures*, *in* TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 117-22 (2004).

227. *See*, *e.g.*, James Bicksler & Andrew H. Chen, *An Economic Analysis of Interest Rate Swaps*, 41 J. FIN. 645, 652 (1986); Phyllis Plitch, *Esoteric Tactic for Investors Grows Popular*, WALL ST. J., May 27, 1997, at B105B (describing the use of collars).

228. *See*, *e.g.*, Farhad Aghdami, *Income, Gift, and Estate Tax Planning with Life Insurance*, ALI-ABA's Direct-to-Desktop CLE Course Forms, *at* http://d2d.ali-aba.org/_files/thumbs/rtf/ CK025-05AghdamiLifeIns_thumb.pdf (last visited Feb. 1, 2005).

229. I.R.C. § 102 (2004).

230. I.R.C. § 1014 (2004).

231. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521, 115 Stat. 71 (2001).

answer. The very rich are relatively few, and their ways are more or less a secret.[232] Certainly, plenty do follow Tax Planning 101, in some form; the advice is readily available.[233] It is also apparent, from the facts that some estates pay estate taxes and that some among the living do indeed pay some capital gains taxes, that not all who could take the game to its limits do so. Quantifying the narrow bottom-line consequences is elusive. But these very questions (i.e., how many people avoid capital taxes?) form the analytic basis for a consequentialist defense of maintaining the status quo with its porous income tax.[234] If few individuals actually take Tax Planning 101 to or near its limits, perhaps things are not so bad after all, contra to Andrews's and other critics' dire descriptions of the way things are.

Yet things in tax today are bad, and for several reasons notwithstanding the intractability of the empirical questions over Tax Planning 101's actual breadth. First, there can be no doubt — certainly none of the critics calling for more empirical analysis or pressing the consequentialist objection raise any doubts— about the analytic facts of the matter, that is, about the legal steps in Tax Planning 101's buy/borrow/die advice. This is basic tax. Yet the mere existence of this legal structure raises troubling questions of both equity and efficiency. If some but not all who have capital take advantage of Tax Planning 101, in whole or in part, what does this tell us about the fairness of the tax system? The essence of the claim that tax for those with capital is voluntary is not that no one with capital pays taxes — people do voluntary things, even voluntarily pay taxes — it is rather that no one with capital *has* to do so.[235] There are perfectly legitimate ways for people with property to avoid paying any federal taxes. This is not so — it is dramatically not so — for people earning labor wages, as we shall see. A system of tax that marks radical distinctions between the sources of present consumption, and that turns further on wealthy taxpayers' varying degrees of tax aversion and access to information — not even terribly sophisticated information, for the basics of buy/borrow/die are indeed fairly basic — is at best a highly suspect system.

232. *See* Douglas Holtz-Eakin, *The Uneasy Empirical Case for Abolishing the Estate Tax,* 51 TAX L. REV. 495, 509-11 (1996) (discussing the difficulty in gleaning the motives and techniques of wealth transfers).

233. The advice can be found readily enough, for example, in such bestsellers as KIYOSAKI & LECHTER, *supra* note 202; POLLAN & LEVINE, *supra* note 169; *see also* MCCAFFERY, FAIR NOT FLAT, *supra* note 2 (describing and referring to numerous popular tax planning books). Evidence from sophisticated econometrics that we collect little if any revenue from capital taxes also suggests the point. *See* Roger Gordon et al., *Do We* Now *Collect Any Revenue from Taxing Capital Income*? 89 J. PUB. ECON. 981 (2004).

234. *See* Geier, *supra* note 197.

235. *See* McCaffery, *A Voluntary Tax?*, *supra* note 202; Gordon et al., *supra* note 233.

Second, and central to the analysis to follow in this subsection, the mere analytic facts of Tax Planning 101 — and *not* the breadth of their actual incidence — constrain important matters of practical tax design. In the language of economics, features such as low tax rates on realization are "endogenous" to an income-with-realization regime. There is simply no very good way, under an "income" tax with the realization requirement as now construed, to heavily burden capital: If taxpayers are not flocking to advisers to avoid a 15 percent capital gains tax, might they not do so at a 40, or 50 percent level? Evidence that some taxpayers pay some capital gains taxes at the favorable rates that persist today does not contradict the fact that these are, indeed, favorable capital gains rates.[236] The present structure of tax haunts the possibilities for tax's better future.

Third, the discussion might be effete, lacking in practical urgency, if the present regime, with its income-plus-estate taxes, embodied the only meaningful promise of getting at capital and its yield at all. The most strident critics of any form of consumption tax insist on the yield-to-capital norm, though they do not use this language.[237] To such critics, getting some tax on some capital is better than getting no tax on any capital, which is what they take a consumption tax to offer. But this false dichotomy follows only from the flawed traditional view of tax. Once we understand that a progressive postpaid consumption tax gets at some of the yield to capital, and in just the cases in which it is most compelling to do so — and also as we come to see that the structure of a postpaid consumption tax changes the nature of the arguments over the rate structure, allowing for more, not less, progression in them — we are no longer left clinging to a porous income tax as the sole hope for reaching capital and its yield. On ideal terms, an income tax overshoots its mark by double-taxing all capital come what may; in nonideal terms, an income tax fails minimal standards of fairness and rationality by taxing the yield to capital only among those most willing to pay it, or unwilling or unable to plan around it. A better way exists.

The balance of this subsection traces out a few of the analytic elements of the present income tax regime that have followed in the structural wake of *Macomber*.

a. Capital gains preferences. The leading example of a provision in current law that follows from *Macomber* — a practical concession to the fact that we have an income-with-realization tax — is the preferential rate for capital gains.[238] This is the tax rate that gets

236. And see Dodge & Soled, *supra* note 220, for a suggestion that taxpayers are dramatically under-stating their true capital gains.

237. *See, e.g.*, MURPHY & NAGEL, *supra* note 6; SLEMROD & BAKIJA, *supra* note 7, at 10-13; Alstott, *supra* note 6; Deborah A. Geier, *supra* note 197; Rakowski, *supra* note 15.

238. I.R.C. § 1(h) (2004).

imposed when and if a taxpayer sells or otherwise disposes of her long-held, capital assets.[239] This rate has long been set at a fraction of the "ordinary" tax rates that fall on labor and the regular yield to capital in the form of interest and dividends. It is now capped at a maximum 15 percent, having been reduced from 20 percent in 2003 tax legislation.[240]

Of all the arguments mustered in favor of a capital gains preference, the only truly compelling one is brute necessity in the face of Tax Planning 101: Who would ever sell an asset and incur a 90 percent, or 70 percent, or even 40 percent tax when she could borrow against it and spend away, tax-free?[241] The realization requirement generates a so-called lock-in effect, set in motion by *Macomber*: a wedge between an owner's willingness to sell a given asset and a buyer's willingness to pay for it, all on account of the built-in tax liability. Suppose, for example, that Mrs. Macomber had a personal subjective valuation in her stock of $800; a third party buyer would willingly pay her $1,000. This is a deal that wealth (and welfare) maximizing suggests ought to happen. But if, on sale, Mrs. Macomber would have to pay $400 in taxes, her personal gain from the exchange would be only $600, less than her subjective valuation. Since Mrs. Macomber quite rationally cares only about her after-tax return, the deal does not transpire. At high enough tax rates, there are many deals that do not take place. The resulting lock-in effect threatens to shut down the economy: assets will not trade and, therefore, will not go to their highest and best use and users. This problem, in simple terms, is a function of the timing of tax: by making sales and exchanges trigger tax, an income-with-realization requirement deters sales and

239. See I.R.C. §§ 1221 (2004), 1222 (2002) for a definition of capital assets.

240. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 301, 117 Stat. 758 (2003).

241. Other common arguments for a capital gains preference are simply not convincing. For example, there is an argument that much of the gain from the sale of an asset reflects compensation for inflation. This argument, made before general rate-bracket indexing, lacked a strong claim to fairness, because much of the return to *human* capital, too, compensated for changes in the inflation or monetary rate. After rate-bracket indexing became fully effective, the capital gains argument lacked much force. Further, indexing of an asset's basis for inflation is a far better reaction to the "problem" of inflationary gain than a crude discount to all assets held a year or more. Another argument is that capital gains can result in "bunching," or the temporary elevation of a taxpayer into a higher-rate bracket. In fact, the evidence on bunching of capital realizations is slim; and capital market transactions, such as installment sales, (*see* I.R.C. § 453 (2004)) can deal with the problem, as could a more targeted averaging mechanism in the tax laws. And again, it is unclear why there should be solicitude for the taxpayers with financial capital who suffer this problem, when there is no adjustment for those with human capital who also fall victim to bunching. This Article is an attempt to make the smoothing phenomenon general, and to be indifferent to the financial/human capital source of the problem. All that said, however, the lock-in effect *is* a compelling argument for a capital gains preference. *See* Edward J. McCaffery, *Capital Gains: What's the Point, and Are We Missing It?*, 43 TAX NOTES 223 (1989).

exchanges. This is not the case under a consistent postpaid consumption tax: sales or exchanges of any investment asset followed by reinvestment of the proceeds in other assets do not trigger tax — think of making adjustments inside an IRA or 401(k) plan. All that triggers a tax under a postpaid consumption tax is the decision to spend resources on private preclusive use.

Under an income-with-realization tax, some preference for capital gains is needed to lubricate the wheels of commerce, to keep the game going. All that is left is to haggle over the price, as the saying goes, and the political system is indeed constantly flirting with lowering the rates further. By deferring Mill's "second" tax, *Macomber* moves the system toward a prepaid consumption tax; by lowering the magnitude of the ultimate second tax hit, capital gains preferences — which follow from *Macomber* and the lock-in effect that a realization requirement generates — take us further in that direction. Of course, holding assets until death in the manner of Tax Planning 101's buy/borrow/die strategy is the limiting case: Here, the second tax, like Beckett's Godot, never comes.[242]

Capital gain preferences are a microcosm of what is wrong with the status quo. We have seen, with Vickrey, that the principal reason to have a comprehensive individual tax system is to make individuated judgments of the appropriate progressivity of effective tax burdens. But the low rate on capital gains, dictated by the flaws of an income-with-realization tax, is a crude and across-the-board affair — it is not individuated at all. A capital gains preference is also source driven, a distinction based on the type of asset held and sold. It does not matter how one uses the proceeds — to smooth or to enhance, for oneself or another. Progressivity suffers, and individuation suffers, on the altar of the practical constraints of analytic tax system design.

b. Corporate dividend preferences. The 2003 tax act — one of several leading exhibits in making out the case that practical tax policy is moving towards a flat wage tax — not only lowered the capital gains rate to 15 percent, as discussed above, but it also extended this rate to corporate dividends, which had traditionally been taxed at ordinary income levels.[243] The lowered or nontaxation of corporate dividends is an intricate economic matter that turned out to be an intricate political one as well. For present purposes, two themes are important.

One, this development plausibly follows from the structure of an income-with-realization tax. Just as *Macomber* generated a lock-in effect at the level of individual asset owners — generating a

242. Dodge & Soled, *supra* note 220, suggest taxpayers aren't waiting for Godot, either: They are taking matters into their own hands, overstating basis and thereby understating gain. I.R.C. § 1001(a) (2004).

243. Jobs and Growth Tax Relief Reconciliation Act § 302; *see also*, STEUERLE, *supra* note 9, at 224-25.

disincentive for them ever to sell their holdings — so too did it generate a lock-in effect, dubbed a "retained earnings trap," at the corporate level. Focusing solely on the individual tax consequences, a wealthy investor like Dodger would understandably look askance at a corporation paying him large cash dividends, taxable at ordinary rates that hit 90 percent and higher in the twentieth century. Better for the corporation to keep the cash itself and reinvest, so that the value of Dodger's shares would grow tax-free, like Mrs. Macomber's, until and unless he decided to trigger a realization event by a sale, at which time the tax would fall due at the much lower individual capital gains rates. The retained-earnings trap gave American corporations a good reason to hoard cash; at one point recently, Microsoft had $56 billion in cash on hand.[244] One way to get corporations to disgorge their cash holdings — making companies smaller in the process — is to lower or eliminate the tax on corporate dividends at the individual investor level.[245]

Two, the corporate dividend tax rate reduction is yet another step towards a relatively flat prepaid consumption tax. Tax Planning 101 points the way for those with capital to avoid paying any further federal tax whatsoever.[246] But for those with stocks of capital unwilling or unable to take this advice, life continues to get better, tax-wise, in any event. Virtually all subsequent taxes on capital are being eliminated or reduced. And as with the capital gains preference, an argument for the normative propriety of a corporate dividend preference is not an individuated argument at all: anyone who owns corporate stocks will see her dividends taxed at 15 percent, however wealthy she is, and for whatever use she puts the cash.[247]

c. Other consumption-tax elements. Preference for those capital gains actually realized and corporate dividends received are just two tips of a large iceberg. As Andrews was well aware, consumption tax elements abound in the so-called income tax. But what has not been generally noticed, on account of the continued hegemony of the traditional view of tax, which has equated all forms of consumption tax, is how much of the current income tax is in fact a specifically

244. Brier Dudley, *Microsoft's $75 Billion Plan: Share Wealth with Investors*, SEATTLE TIMES, July 21, 2004, at A1; Gary Rivlin, *Microsoft to Pay Special Dividend to Stockholders*, N.Y. TIMES, July 21, 2004, at A1; *see also* Jonathan Fuerbringer, *Companies With Cash Hoards Don't Necessarily Pay It Out*, N.Y. TIMES, July 22, 2004, at C7.

245. The incentive appears to have worked. *See* CHRIS EDWARDS, REPLACING THE SCANDAL-PLAGUED CORPORATE INCOME TAX WITH A CASH-FLOW TAX 23 (Cato Inst., Policy Analysis No. 484, 2003), *at* http://www.cato.org/pubs/pas/pa-484es.html (Aug.14, 2003).

246. *See supra* Part V.A.1.

247. Del Jones, *CEOs, Heirs to Stock Fortunes Win Big with Cut*, USA TODAY, Jan. 9, 2003, at 3B (noting that each of the five Walton heirs would save $197 million annually in taxes if dividends were tax-free).

prepaid consumption or wage tax model. Consider a few more doctrinal matters.

In cash-value life insurance, a taxpayer overpays for the pure actuarial or "term" component of insurance. The insurance company then invests the excess, on her account. The taxpayer pays no tax, basically because of *Macomber*, on the "inside build up" of appreciation, even if the insurance company buys assets such as bonds that would produce ordinary income in her hands. When she dies and her heirs get the proceeds, these are income tax-free to them,[248] and with rather trivial planning, the policy's value will not count in her estate for federal tax purposes.[249] As with most instances of clever tax planning, this device does not work only for the altruistic or intergenerationally minded; taxpayers are free to borrow against the cash value of their policy, tax-free. In such a case, when the insured dies, the insurance company first pays itself off, and her heirs — if she has taken this game to its limit — get nothing.[250] This is simply a one-stop shopping way to play Tax Planning 101, buy/borrow/die. It is also prepaid consumption tax treatment: the taxpayer pays taxes on her wages, uses them to pay insurance premia, and never again pays tax.

For a good many Americans, their most significant asset is a house. Although home mortgage interest is deductible, principal payments are not. The economics of home ownership work under a prepaid consumption tax model. One buys the asset with after-tax funds, but does not pay tax on its yield — the very important opportunity cost benefit of not having to pay rent. Further, when a married couple sells their house, they get to take away up to $500,000 of gain, tax-free.[251] That will cover most homeowners, of course; for those with larger shares of appreciation, there might be a 15 percent capital gains tax on the excess of gain over $500,000. The saga of the taxability of home sales under the income tax, like so much of tax today, owes much to *Macomber*. The realization requirement means that capital appreciation in personal residences gets ignored as it accrues, awaiting an ultimate sale or disposition. But here too there is a lock-in effect, deterring families from "trading up" to get larger homes, or moving to a different area for job-related or other reasons. To deal with these problems, the law employed a "rollover" provision for many years, allowing the built-in tax gain to follow the family's real estate moves.[252]

248. I.R.C. § 101 (2004).

249. *See generally* I.R.C. § 2042 (2004).

250. *Cf.* Knetsch v. United States, 364 U.S. 361, 364-66 (1960) (describing a scenario in which borrowing against a life insurance policy would have left a "relative pittance"). Although Knetsch lost his case, much sophisticated planning with life insurance persists to this day.

251. I.R.C. § 121 (2004).

252. I.R.C. § 1034 (1988) (repealed 1997).

But then the elderly had a problem: Once the kids had left the nest, and they wanted a smaller home or to relocate to a less expensive area, they faced an exploding tax time bomb. So Congress dealt with their problem, excluding gain when taxpayers older than 55 sold a residence.[253] Perhaps mercifully, President Clinton swept away many of the subtleties, allowing the $500,000 per couple exemption discussed above. Each step in the story made some sense. But, sweeping all details aside, what we are left with is an important asset fully taxed for most taxpayers on the prepaid consumption tax model: houses are bought with after-tax dollars, and their yield is never again taxed.

Retirement savings are a final and very important example of consumption-tax treatment. I shall discuss them below, as an ad hoc deviation from an income tax. For these provisions follow not so much from the structure of an income-plus-realization tax, as from conscious decisions to deviate from either an income or an income-plus-realization ideal. It is noteworthy, however, that there has been a trend in the retirement savings area, which began on the postpaid consumption tax model, towards the prepaid one. Together with the basic tax planning of buy/borrow/die, lower tax rates on capital realizations and corporate dividends, cash-value life insurance, and the taxation of home-ownership, the new developments in retirement savings help to move tax towards a world in which citizens will pay taxes on their wages, under a compressed rate structure, and never again. This is the world of prepaid consumption, or wage, taxation.

B. *Ad Hoc Deviations*

This section discusses a variety of more conscious, deliberate prosavings provisions, such as pension plans and IRAs, that have been features of the income tax since the 1940s.[254] Unlike the structural elements just canvassed, which followed from the income-plus-realization tax in the wake of *Macomber*, these prosavings mechanisms have resulted from a deliberate rejection of the income-tax model. Policymakers wanted to encourage savings and wanted to avoid Mill's double tax. They added statutes to achieve this effect.

Significant technical problems follow from engrafting prosavings provisions onto an income tax, however, on account of the analytic

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253. I.R.C. § 121 (1988) (repealed 1997).

254. The Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798 (codified as amended in scattered sections of 26 U.S.C.) first made employer pension contributions tax deductible. IRAs were introduced in 1974 in the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, § 202, §§ Stat. 829, 958-66 (codified as amended at 26 U.S.C. §§ 219, 408 (2000)). *See generally* Steven F. Venti & David A. Wise, *Government Policy and Personal Retirement Saving*, 6 TAX POL'Y & ECON. 1, 37-38 (1992) (data suggests IRA program induces "substantial new saving").

inconsistency. Because one can borrow tax-free under an income tax, there is no logical assurance that savings will, in fact, increase with any nominal prosavings provision within such a tax: a taxpayer can open up an IRA with $2,000, using one hand, and borrow $2,000 on a credit card, using the other. The evidence is mixed in terms of the empirical questions of how much various retirement and other savings provisions actually increase savings.[255] But the claim that the center we have chosen cannot hold is once again not a narrowly empirical one; it is not based on aggregate macroeconomic statistics and our varying, imperfect understanding of them.[256] The critique is based instead on the analytic structure of tax, and what this says about tax's fairness, efficiency, complexity, and possible reform. It is simply a difficult and scattershot affair to try to encourage and reward savings within a tax system ideally designed to double tax savings.

Still, the mere presence and persistence of the ad hoc deviations from an income tax, however ineffective, underscore the appeal of the ordinary-savings norm. The structural gaps followed, more or less from brute necessity, after *Macomber*. The ad hoc deviations, in contrast, have been repeatedly chosen, consciously and deliberately, by tax policy makers. This makes their implicit norms all the more compelling.

1. *Retirement Savings*

Retirement savings — which, with home equity, are the major assets for most Americans who have any assets at all (and many Americans do not)[257] — are taxed primarily on the postpaid consumption tax model; a taxpayer gets a deduction when she puts money into a tax-favored account, and she pays tax when she withdraws funds. A growing trend in tax is to allow an option for taxpayers to choose a retirement savings plan structured under the prepaid consumption tax model, such as the Roth IRA, instead of the traditional postpaid approach. Under these variations, there is no tax deduction up-front, and there is no back-ended tax on withdrawal: this is an equivalent matter, assuming constant tax rates, as Ant and Grasshopper helped us to see.

255. *See* Bell, Carasso & Steuerle, *supra* note 149 (reporting that tax incentives for retirement programs in 2004 cost the government $112 billion in 2004, while all personal savings were $100.8 billion that year); *but see generally*, Venti & Wise, *supra* note 254, at 25 (suggesting IRA programs do induce new saving).

256. Our understanding is imperfect in large part because the problems are intractably hard. There are problems of joint causation and a great deal of noise in the economic statistics.

257. U.S. Dep't of Commerce, Statistical Abstract of the United States: 2003, at 469, 742 (123d ed. 2003). Nearly half of all American families do not have a retirement plan while about a third of all American families do not own a primary residence.

The proliferation of retirement savings provisions resulting from the addition of a prepaid track to the longstanding postpaid one is another side effect of the influence of the traditional view, equating prepaid and postpaid consumption taxes, and it has added considerable complexity and confusion to tax. It is also not irrelevant that Congress gets its one tax today under the prepaid, Roth-style account model, and thus it has a short-term incentive under contemporary budgeting rules to prefer this approach.[258] Prepaid consumption tax savings plans also avoid the arbitrage problem noted above: there is no reason to borrow funds with one hand in order to "save" with the other, since there is no immediate tax benefit to savings.[259] There is also no reason to borrow in lieu of making withdrawals from a qualified account (or in lieu of realizing gains), as Artful Dodger might do,[260] because there is no tax on withdrawal, aside from penalties for early withdrawal in some cases. And yet moving towards a prepaid consumption tax model has a cost, one obscured by the traditional view but recognized by the new understanding of tax. This model does not allow for smoothing. Recall Figures 1-3, above, representing the typical pattern of earnings and spending in a taxpayer's life. The single tax under the prepaid model falls due at the time of labor market earnings, typically in a worker's peak income — and hence most highly taxable — years. Because there is no way to escape the burden of wage taxation, prepaid consumption tax savings plans are in tension with highly sloping marginal tax rates, whereas a postpaid consumption tax gives taxpayers a mechanism for avoiding the burden of higher rates — save, do not spend. It is not therefore surprising that the contemporary conservative tax reform movement has been moving towards prepaid consumption tax savings plans — as a step on the path towards flat taxes.

The general tax treatment of retirement savings, under traditional IRAs and pension plans such as 401(k)s, reflects the appeal of the ordinary-savings norm and the appeal of favoring (or not disfavoring) capital-smoothing transactions. The original idea was to take some otherwise taxable income out of a worker's high-earning, middle-aged years and move it backward to the time of retirement: backward smoothing, in the manner of Figure 2. As noted above, these structures lack coherence under an income tax. When a taxpayer borrows and also opens an IRA, there is no net saving, just a tidy tax deduction. This is yet another instance where we can now understand

258. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 50; Elizabeth Garrett, *Accounting for the Federal Budget and Its Reform*, 41 HARV. J. ON LEGIS. 187, 192-93 (2004).

259. On the other hand, one can easily shift *existing* taxable savings into a prepaid account, eliminating capital taxes without new savings. *See* Roger Gordon et al., *Toward a Consumption Tax, and Beyond*, 94 AMER. ECON. REV. 161 (2004).

260. *See supra* Part V.A.2.

that the true problem with the status quo, which seems as if it lies in the inconsistent treatment of savings — where Andrews had seen its "worst inequity and distortion" — actually relates to the inconsistent treatment of *consumption*. The taxpayer who both borrows and opens a deductible IRA is able to consume today, without any savings, and pay tax tomorrow; so too with the taxpayer who borrows in lieu of withdrawing from her tax-favored account. In both cases, there is a deferral and a possible lowering of the ultimate tax rate, but no savings.[261]

2. *More and More*

There have been two important recent developments in the field of ad hoc, prosavings deviations from the income tax. First, these accounts have extended beyond retirement uses. There are now medical and educational savings accounts,[262] and the Bush Administration has proposed further savings accounts unlimited as to their use.[263] Second, the accounts are more and more likely to be structured on the prepaid consumption tax model.

Consider, for two important examples of both trends, the Coverdell Educational Savings Accounts (ESAs), formerly known as the Education IRAs, and the Section 529 Qualified Tuition Plans (QTPs).[264] The former works along an IRA model, but one of the Roth or prepaid variety. An ESA can be set up for each "qualified beneficiary," or child, and persons can contribute up to $2,000 per year per account. There is, of course, the usual array of mind-boggling provisions, such as ceilings for those who make too much income, and rules for coordination with other proeducation features, such as the "Hope" or (not equivalently) "Lifetime Learning" credits.[265] QTPs are more complicated still: they must be maintained by a state or a

261. It is worth noting, however, that the taxpayer who plays this game, using traditional IRAs or pension plans, cannot escape tax altogether, as can the taxpayer with financial capital who plays Tax Planning 101: some tax must be paid on the withdrawal of funds from the IRA or qualified pension account, even if the taxpayer dies before the withdrawal. I.R.C. § 691 (2004) (income in respect of decedent). This is yet another example of the system's far greater solicitude for taxing wages than the yield to capital.

262. *See* INTERNAL REVENUE SERV., PUB. NO. 969, HEALTH SAVINGS ACCOUNTS AND OTHER TAX-FAVORED HEALTH PLANS (2004), *at* http://www.irs.gov/publications/p969/ (last visited April 5, 2005); INTERNAL REVENUE SERV., PUB. NO. 970, TAX BENEFITS FOR EDUCATION (2004), *at* http://www.irs.gov/pub/irs-pdf/p970.pdf (last visited April 5, 2005) [hereinafter TAX BENEFITS FOR EDUCATION].

263. *See* Daniel Altman, *Taxes and Consequences: The Second Term Begins*, N.Y. TIMES, Nov. 7, 2004, § 3, at 4 (discussing *inter alia* Bush Administration proposals for lifetime savings and universal retirement accounts).

264. I.R.C. § 529 (2004).

265. *See* I.R.C. § 530 (2004); TAX BENEFITS FOR EDUCATION, *supra* note 262, at 9-24, 40-49.

"qualified educational institution," and their coordination provisions are intricate. Still, at the end of the day, QTPs have more generous contribution limits than ESAs. QTPs, too, work along the prepaid consumption tax model: taxpayers can put in large sums of money with after-tax dollars and rest assured that the investment yield will not be subject to any second tax on withdrawal, provided that the formidable terms and conditions of the statutory grant are met.[266]

An interim bottom line is that the model of allowing savings to escape double taxation, begun in the 1940s for retirement savings, has continued to grow and develop under the so-called income tax, by conscious government policy. The theme now extends beyond retirement savings to medical- and educational-related savings. And there has been a dramatic shift, barely noticed by those working under the traditional view of tax, towards having the single tax fall at the time of initial labor market earnings, not the time of ultimate use.

C. *Tax Shelters and the Noble Failure of TRA 86*

Both the deep structural gaps and the increasingly ad hoc, pro-savings provisions move the income tax towards a consumption tax, as Andrews and others have long pointed out. Further, in a distinction made salient by the new understanding of tax, the law is increasingly moving towards a specifically prepaid consumption, or wage, tax. All "second" taxes on the yield to capital are voluntary under Tax Planning 101; those that do fall are deferred and come due at low marginal capital gains rates — rates whose very existence owes to the presence of the structural gaps themselves. More and more ad hoc savings provisions add to the trend, especially as they are created more and more frequently on the prepaid consumption tax model.

The other side of the coin in tax is what has been happening with labor market returns, or wages. The income tax per se makes no attempt to reach beneficent market returns,[267] and we have just considered its seriously porous commitment to taxing capital market returns. If the taxation of wages were porous, too, there would be nothing left to tax. But it is not porous: Even as the so-called income tax system has weakened in its taxation of capital market returns, it has strengthened its commitment to taxing wages. Ad hoc savings provisions along the prepaid model do exactly this: by denying any current deduction, they ensure that wages are taxed, and taxed now; by not taxing withdrawals, they assure that the yield to capital is never taxed. On the other hand, nothing in Tax Planning 101 is relevant to

266. *See* I.R.C. § 529 (2004); TAX BENEFITS FOR EDUCATION, *supra* note 262, at 50-53. The terms and conditions may include making the withdrawals before 2010, when the law is presently set to expire.

267. *See* I.R.C. § 102 (2004).

citizens who must live off the yield to their human capital, that is, off of their labor market wages, often paycheck to paycheck. Indeed, for many who are building up such human capital by borrowing and schooling themselves — law students, say — a depressing reality lies in wait. These unlucky wage-earners-to-be will have to pay off their student loans with after-tax dollars drawn from their high bracket years ahead. Their chosen path through life makes them income bunchers, who must rely on capital transactions to smooth consumption — which neither an ideal income tax nor a prepaid consumption tax accommodates their doing. The actual income tax, meanwhile, accommodates smoothing only erratically, allowing backward smoothing to some extent, at a price of the complexity of the retirement and other ad hoc savings provisions, but not forward or anticipatory smoothing via debt at all. And as the actual income tax moves ever closer to a prepaid consumption or wage tax, even this accommodation for backward smoothing is at risk.

Much of the history of tax planning in the United States has been concerned with the situation of high wage earners and their search for "tax shelters." The general strategy of a tax shelter (at least before 1986)[268] is to get some of the benefits that the propertied classes have long enjoyed under the basic structure of an income-with-realization tax as a wage earner: to hide or "shelter" one's wages from the tax collector. The propertied classes do not need shelters, by and large, because the realization requirement, and the simple steps in Tax Planning 101 that follow from it, serve to keep their material resources away from the tax collector perfectly, effectively, and legally.[269] It is those with large labor market gains who need help. Prior to the epochal Tax Reform Act of 1986 ("TRA 86"),[270] sheltering for such wage earners had become almost as easy as avoiding taxes for property owners: it was simple enough to play the game with other people's money, or, indeed, with no money at all. The gaps in tax opened up on the capital side had leaked over to the labor-market side, threatening the entire system as a revenue-raising vehicle. But slowly, systematically, as marginal tax rates have come down (a top rate of 70 percent when Ronald Reagan took office in 1981 has now

268. In the 1990s, a new generation of "corporate tax shelters" arose to offset corporate income taxes, but also to shelter the large capital gains occasioned by the boom time 1990s. In the latter case, the corporate form exploited a gap in the coverage of I.R.C. § 469 (2004). *See* Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters*, 54 SMU L. REV. 3 (2001).

269. *See generally* DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER-RICH — AND CHEAT EVERYBODY ELSE, 1-19 (2003).

270. Tax Reform Act of 1996, Pub. L. No. 99-5511, 100 Stat. 7085 (codified as amended in scattered setions of 26 U.S.C.).

been cut in half[271]), and as the structural and ad hoc opportunities to avoid "second" taxes on the yield to capital have expanded, the means for sheltering wage income have dried up. This continues the central theme of the practical critique of the status quo: the so-called income tax system has morphed into an effective wage, or prepaid consumption, tax. To understand this point fully, consider the shelter game, then and now.

1. *Some Quick and Dirty Examples*

Let us reflect on the way things were, prior to the 1986 Act, in order to understand where we are and where we are heading. Simply to make the point, take four fairly basic tricks of the ancient trade of tax sheltering, here given evocative names and hypothetical taxpayers to illustrate.

The interest dodge: Susie, who has no capital, is about to earn $100,000 a year as an associate in a large law firm. She borrows $1,000,000 at 10 percent interest. With an unlimited interest deduction,[272] she offsets her $100,000 salary completely on her tax return. With her $1,000,000 in cash, she plays Tax Planning 101, just like the Artful Dodger. Susie buys capital-appreciating assets, such as growth stocks, and borrows against the appreciation to get cash to consume. She has no net wealth, because her liability offsets her assets. She consumes $100,000. She pays no income tax.

The simple straddle: Joe is in the same boat as Susie: about to make $100,000 a year as a lawyer, with no cash in his pocket. He borrows $200,000 on a margin account, and buys perfectly offsetting stock positions — in essence, he puts $100,000 on each side of a "heads or tails" coin flip. (He can do this with a put and a call option on the same commodity, or by going long and short on the same stock.) One position is guaranteed to double in value; the other to become worthless. Joe sells and then writes off the worthless one, claiming a $100,000 loss that, with unlimited loss offsets,[273] wipes out the tax liability on his salary from the law firm on his tax return. Joe holds his $200,000 winner, which precisely offsets his loan balance. Like Susie, Joe has no net wealth. Also, like Susie, he pays no income tax on his $100,000 salary. He, too, can consume away, tax-free.

The classic shelter: Sara is graduating from medical school, and is about to start earning $100,000 with no assets in hand. She buys an old

271. In 1981, the highest rate was reduced from 70 percent to 50 percent. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981). Under the Jobs and Growth Tax Relief Reconciliation Act, the top rate was cut to 35 percent.

272. Prior law I.R.C. § 163 (1982) (amended 1986).

273. The present law does not contain such unlimited loss offsets. *See* I.R.C. § 1211 (first added in 1954, amended to current assets in 1986) (2004) (capital loss offset rule).

hotel in Arizona for $3,000,000, giving the owner a nonrecourse note for virtually the whole amount (no money down!).[274] Sara leases the hotel back to its owner, setting the rent she is owed on the hotel equal to the interest she owes on the note, which has a balloon payment due and payable in 30 years. Meantime, with a 30 year depreciation schedule, Sara gets $100,000 in ordinary income deductions each year.[275] Sara, too, like Susie and Joe, has no net assets; the liability offsets the gross value of her holdings. Like her friends, she also pays no tax on her $100,000 salary. She will worry about what happens much later, in Year 31.[276] For now, she consumes away, tax-free.

The kiddie shift: Tom is about to become a doctor, too, earning $100,000. He has four young children. Tom decides to buy a small office building, perhaps using debt financing, which would generate a nice tax deduction[277] to sweeten his basic plan, and then gifts fractional shares of the building to his children. Tom then pays each of his offspring rent. The rent is a business deduction for Tom,[278] bringing his taxable income down, and just so happens to fall in each of his children's "zero bracket." Tom and kin pay no tax on the transferred amounts, which Tom directs his children to use for their basic food and clothing — indeed, he can do this himself, as their natural guardian.[279]

More elaborate examples of the ancient sheltering art could be put forward, but these four simple tax-planning strategies serve to illustrate the point perfectly well. All were alive and flourishing, in one form or another, for long periods in American tax law. The interest dodge, the classic shelter, and the kiddie shift were pretty much in full flower coming into the 1986 Act; either of the first two alone was sufficient, taken to its limits, to make the entire income tax voluntary, even for those without their own financial capital stakes to play Tax Planning 101.

274. Facts based on *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), which did not work. *But see* Comm'r v. Tufts, 461 U.S. 300 (1983) (illustrating a simple case that did work).

275. *See* I.R.C. §§ 167, 168 (2004).

276. Under *Tufts*, she will have capital gains of $3,000,000 — a small price to pay for $3,000,000 worth of tax-free ordinary income for 30 years. And, in any event, she can always find another shelter, holding them until she dies, thereby playing Tax Planning 101. *See supra* Part V.A.1.

277. *See* I.R.C. § 163 (2004); *supra* note 272 and accompanying text. Under an unlimited interest deduction, as generally obtained prior to 1986, even a loan to finance a gift would generate deductible interest. *But see* I.R.C. § 265 (2004).

278. *See* I.R.C. § 162 (2004).

279. *See, e.g.*, Brooke v. United States, 468 F.2d 1155 (1972).

2. *What TRA 1986 Did, and Did Not, Do*

The traditional view of tax sees the choice of broad-based systems as one of income versus consumption. Andrews's important articles from the 1970s had opened up an attractive avenue for tax reform, in the form of a progressive postpaid consumption tax. The influential *Blueprints for Basic Tax Reform* had traced out the two perceived forks in the road, perfecting the income tax or moving towards a consistent consumption tax.[280] TRA 86 ostensibly took the income-tax path.[281] This epochal legislation's general strategy was to widen the income tax base, by eliminating scores of exemptions, exclusions, and deductions, in order to bring tax rates down. In particular, TRA 86 shut down all the shelters mentioned above, with the exception of those already shut down.[282]

There is thus no longer a general deduction for personal interest, and investment interest is subject to a "netting" rule:[283] the interest dodge is dead. Susie can still borrow money, but she cannot use the interest to offset her salary for tax purposes. Pure straddles had already been attacked, and the capital loss offset rules generally limit the usefulness of Joe's simple straddle idea.[284] The sweeping passive activity loss rules of section 469 effectively shut down the classic shelter in most of its incarnations.[285] Susie can still run a rundown hotel, but she cannot use the tax losses generated thereby to subtract from her salary as a doctor on her tax forms. The "kiddie tax" killed Tom's clever idea, again in most instances, by putting children in the same marginal tax bracket as their parents for unearned income.[286] Tom can still give his office to his children and pay them rent, but he will find them paying the same tax he otherwise would. In sum, TRA 86 was systematic in curtailing tax shelters, thereby stopping the bleeding in tax and enabling lower tax rates on a broader tax base.

But — and herein lies the rub — the watershed TRA 86 did nothing about Tax Planning 101 or any of its three simple steps. TRA 86 did not touch the realization requirement of *Macomber*, although

280. *See* BRADFORD ET AL., *supra* note 8. Note that these are exactly the options that the Bush Administration, early in its second term, seems to be considering again, this time with a prepaid consumption tax model ascendant. *See* Altman, *supra* note 263.

281. *See* BRADLEY, *supra* note 6.

282. There had already been anti-straddle legislation, I.R.C. § 1092 (added in 1981) and the "at risk" rules limited some shelter games. I.R.C. § 465 (added in 1976).

283. See I.R.C. § 163 (2004), especially 163(d).

284. *See* I.R.C. §§ 1211 (first added in 1954, amended to current limits in 1986), 1092(c)-(f) (introduced in 1981, 2002) (anti-straddle provisions).

285. I.R.C. § 469 (2004).

286. I.R.C. § 1(g) (unearned income of minor children, a/k/a "kiddie tax").

Congress clearly has the power to do so.[287] TRA 86 did not make debt taxable, or a deemed realization event for people with appreciated assets. TRA 86 did not alter or repeal the stepped-up basis rule for assets acquired on death. It is true that TRA 86 repealed the capital gains preference, which resulted in an interim rise in its rate. Capital gains had for a significant time been set at 40 percent of the ordinary income tax rate; thus, the top capital gains rate was 28 percent when Reagan took office with a 70 percent top ordinary rate bracket. When Reagan oversaw his first major tax-cutting bill, the Economic Recovery Tax Act (ERTA) of 1981, the ordinary rate fell to 50 percent. The capital gains rate fell in step, to 20 percent. TRA 86, which instituted a marginal rate bracket of 28 percent on the highest incomes,[288] eliminated any further and specific capital gains rate preference, thus, in essence, restoring the pre-ERTA rate of 28 percent on capital gains. Interestingly, this created a natural experiment to see if capital transactions were elastic to the tax rate; there was, indeed, a spike in sales under the outgoing 20 percent regime. But recall that the capital gains rate, as argued above, is a reaction to the very existence of Tax Planning 101. Since TRA 86 left Tax Planning 101 unchecked, its elimination of the capital gains preference was fragile from the start. A preferential rate soon enough reappeared, with the elder George Bush maintaining the top rate at 28 percent when ordinary income tax rates went up; Bill Clinton reducing it first to 20 percent, then later to 18 percent; and the younger Bush bringing it down to its current 15 percent. As this saga of capital gains preferences played itself out, the simple advice of buy/borrow/die lived on.

What TRA 86 — one of the most sweeping acts of tax legislation ever passed, and the subject of laudatory volumes from the popular press[289] — did was simple. It shored up the status of the "income" tax as a prepaid consumption or wage tax. Shelters for wage earners were shut down or drastically curtailed. Yet people with capital could still buy, borrow, and die to their hearts' content; tax remained voluntary for those with financial capital.

287. *See* CHIRELSTEIN, *supra* note 56, at 73 (explaining that *Macomber*'s realization requirement not constitutional, merely an administrative rule); *see also* I.R.C. §§ 1271-1274 (2002) (o.i.d. provisions) (instances of Congress's imposing tax without realization).

288. *See* I.R.C. § 1 (1986); *see also* McCaffery, *Cognitive Theory and Tax*, *supra* note 43, at 1898 (discussing TRA 86's rate "bubble").

289. *See, e.g.*, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH (1987).

VI. THE MESS WE'VE MADE, PART TWO: BEYOND THE INCOME TAX

Tax policy typically suffers from blinders when it comes to taxes other than the income tax.[290] The personal federal income tax is, indeed, the largest American tax. At least for the time being, the income tax also features relatively high marginal tax rates and rewards at least some sophisticated planning, even after the TRA 86 put a lot of tax shelters out of business.[291] The income tax's size and malleability warrant its status as a relative staple in American law school classrooms. Yet, large as it is, the federal income tax accounts for less than one-half of all federal government revenues, and less than one-third of all taxes in America, state, local, and federal combined.[292] Other taxes must be factored in to any general theory about fairness in tax today.

The new understanding of tax helps us to see the larger context of tax today. For while certain taxes — most importantly the corporate income and gift and estate taxes — are meant to correct for holes in the income tax's commitment to taxing capital, they do not effectively do so. When we widen the lens of our inquiry to consider the state of tax generally in the United States, a surprise awaits: the principal theme advanced in the last Part only deepens. The American tax system, writ large, is moving, seemingly inexorably, towards a consumption tax — and specifically, under the new understanding of tax, towards a prepaid consumption tax — at relatively flat rates. What capital taxes remain are erratic in their operation, unprincipled in their conception, and — not unrelatedly — fragile in their vitality.

This Part explains these comments, beginning with the critically important payroll tax system.

290. This is beginning to change. *See* Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002) [hereinafter Geier, *Integrating the Tax Burdens*]; Andrew Mitrusi & James Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979-99*, 53 NAT'L TAX J. 765, 765 (2000); Deborah A. Geier, *The Payroll Tax Liabilities of Low- and Middle-Income Taxpayers*, 106 TAX NOTES 711 (2005) [hereinafter Geier, *Payroll Tax Liabilities*].

291. *See* Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 45-50 (2003); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 388 (2002).

292. In 2002, federal personal income taxes raised just over $858 billion, or 46.3 percent of total federal receipts of $1.853 trillion, and 30 percent of total government receipts of $2.847 trillion. *See* OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, HISTORICAL TABLES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004, at 29-30, 293 (2003).

A. *Payroll Taxes*

No normative analysis of tax today should ignore the payroll tax system. To begin with, the combined social security and Medicare system is indeed a tax: not only are the exactions from wages mandatory (the classic hallmark of a tax), but they are also untethered from any precise benefit or payback system — social security has long been on a "pay as you go" basis.[293] This means that the benefits system of social security, which indeed has some elements of progressivity in it, can be separated from the contribution or tax part of the system.[294]

The payroll tax is also big. The employee pays 7.65 percent of her pretax wages: 6.2 percent for social security, up to a ceiling presently set at $90,000, plus 1.45 percent for Medicare, with no ceiling.[295] The employer pays a matching share, but the real incidence is all on the employee: this is an employee-specific cost, one that a rational employer must factor into account when considering whether to hire, and how much to pay, an employee. Consider, for example, an employee earning $10,000. She must pay $765 out of her wages in payroll taxes, and her employer must pay a like amount. This means both that her employer considers her labor to be worth $10,765, and that $1,530 has gone to the government on account of her paid work.[296] The full amount of $1,530 — the total tax, including the employer's share — could go to the employee if Uncle Sam released his hold on

293. *See* Geier, *Integrating the Tax Burdens*, *supra* note 290; Geier, *Payroll Tax Liabilities*, *supra* note 290; Edward J. McCaffery, *The Burdens of Benefits*, 44 VILL. L. REV. 445, 453-58 (1999) [hereinafter McCaffery, *Burdens*]. Although payroll taxes have some relationship to benefits — as do income taxes, of course, in some way — I analyze them here solely in regards to their tax burden, on wages.

294. The system is not unequivocally progressive. *See* MCCAFFERY, TAXING WOMEN, *supra* note 72, at 89-105; DANIEL SHAVIRO, MAKING SENSE OF SOCIAL SECURITY REFORM 19-22 (2000).

295. *See* SOC. SEC. ADMIN., PUB. NO. 05-10024, UNDERSTANDING THE BENEFITS 8 (2004), *at* http://www.ssa.gov/pubs/10003.html (last visited Mar. 7, 2005). The ceiling is $90,000 in 2005.

296. Since the employee never sees the employer's share in her pay stub, it is in some ways more accurate to "gross up" her salary, and see that she has paid $1530 out of $10,765, a 14.2 percent rate. *See, e.g.*, DANIEL N. SHAVIRO, EMPLOYMENT POLICIES INST., EFFECTIVE MARGINAL TAX RATES ON LOW-INCOME HOUSEHOLDS, *at* http://epionline.org/studies/shaviro_02-1999.pdf (Feb. 1999). On the other hand, the $10,000 — without any deduction for her share of payroll taxes paid — is what the employee must report to the IRS for income tax purposes, so the 15.3 percent figure used in constructing Table 3, below, is also accurate. On reported wages of $10,000, $1530 goes to the government. Table 3 thus does reflect the taxes paid on reported wages, although it does not precisely track take home pay: this is set at 1 minus the tax rate net of the employer's share of the payroll tax (so a taxpayer making $30,000, say, faces a marginal rate of 22.65 percent and gets to take home 77.35 percent of her next dollar in reported wages, considering the payroll and income taxes alone).

it.[297] (The self-employed see this all much more directly, as they must themselves pay 15.3 percent of their wages up to $90,000, and are allowed an income-tax deduction only for one-half of the total payroll taxes they pay.) The net result is a flat, 15.3 percent tax on labor earnings, starting with the first dollar earned, and extending upwards to $90,000, after which the social security tax ceases and the payroll tax rate drops down to the 2.9 percent (two times 1.45 percent) of Medicare alone.

Table 3 puts together the payroll tax rate structure with that of the basic income tax, using 2003 rate brackets after tax reform.[298] Such tables are difficult to construct with any precision, on account of the considerable complexity within the income tax: varying "zero brackets" based on whether a taxpayer itemizes or not[299] and how many personal exemptions she has;[300] inframarginal rate changes brought on by the earned-income tax credit and its phaseout;[301] the loss of personal exemptions;[302] the alternative minimum tax;[303] and so forth. The table nonetheless gives the basic rate structure facing a single individual taking the standard deduction.[304] It ignores the important EITC available for low-income taxpayers,[305] and so understates the degree of progression in the total tax system, although the EITC also adds a burden onto lower middle class taxpayers.[306] Still, it gives a basic sense of the matter, while helping to illustrate why the EITC is so important. Most importantly, Table 3 shows how big the payroll tax system is, relative to the income tax.

297. It is a mistake to think that simple supply and demand analysis affects this result. The employer is facing the full tax in his wage decisions; the tax works like a simple downward shift in the demand curve, as a per unit tax. The lower after-tax wage obtained by workers may indeed affect aggregate labor supply, but this does not change the fact that existing workers are paying the full burden of the tax.

298. Up-to-date tax rate tables can be found at http://www.irs.gov.

299. I.R.C. § 68 (2004).

300. I.R.C. § 152 (2004).

301. I.R.C. § 32 (2004).

302. I.R.C. § 68(c) (2004).

303. I.R.C. § 57 (2004).

304. It uses $5000 for the standard deduction and $3000 for the personal exemption, creating an effective "zero bracket" of $8000.

305. For general discussion of the EITC, see Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995); McCaffery, *Burdens*, *supra* note 293, at 486-91.

306. *See* MCCAFFERY, TAXING WOMEN, *supra* note 72, at 145-48 (discussing EITC phaseout).

TABLE 3: PAYROLL, INCOME AND COMBINED TAX RATES, SINGLE PERSON, 2003

Income	Payroll Tax	Income Tax	Combined
$0 - 8,000	15.3	0	15.3
$8,001-15,000	15.3	10	25.3
$15,001-36,400	15.3	15	30.3
$36,401-76,800	15.3	25	40.3
$76,801-90,000	15.3	28	43.3
$90,001-151,500	2.9	28	30.9
$151,501-319,500	2.9	33	35.9
$319,501 and above	2.9	35	37.9

An individual taxpayer begins to pay 15.3 percent in payroll taxes right away on her first dollar of wages, with no accommodation for family size, medical needs, or anything else. Thus, over the range from $0 to $90,000, a taxpayer's average or effective payroll tax rate — as well as her marginal one — is 15.3 percent. In contrast, a single person under the income tax would have to earn over $53,000 before her average income tax rate was as high as 15.3 percent.[307] Given that the average annual pay in 2000 was slightly over $35,000 per worker,[308] it should not be surprising to learn that between 70 and 80 percent (or higher) of families with positive taxes pay more in payroll taxes than in income taxes.[309] Yet the payroll tax, alone among major federal taxes — the personal and corporate income and gift and estate taxes — has never been cut.[310]

In any event, it is the aggregate of payroll and income taxes that matters to a rational taxpayer. Table 3 shows the rather compressed rate structure under the payroll plus income taxes combined. It starts at 15.3 percent, quickly hits 30 percent, peaks at $76,800 at 43.3 percent, and then declines precipitously at $90,000, although it never falls below 30 percent or rises above 40 percent. Anyone who earns between $15,000 and infinity in wages pays federal taxes in this narrow band, between 30.3 and 43.3 percent, with the top endpoint at 37.9 percent.

Most important for the new understanding of tax, the social security or payroll tax is a canonical instance of a prepaid consumption

307. The solution to the problem of $0 + .10($15,000 - 8,000) + .15($36,400 - 15,000) + .25($x$ - 36,400) = .153x, where x is the income, and equals $53,505.

308. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 2004-2005, at 410 (124th ed. 2005).

309. *See* Mitrusi & Poterba, *supra* note 290, at 772-74 (the authors find just over 70 percent, but refer to CBO data indicating 80 percent).

310. McCaffery & Baron, *Humpty Dumpty Blues*, *supra* note 49, at 231.

tax. Its single levy is applied up-front as money is earned in labor markets, and never again: no social security "contribution" is asked of returns in the capital or beneficent markets. Combined with the understanding that the nominal income tax is largely now a prepaid consumption or wage tax — the theme of the prior Part — this gives a dark spin to Table 3: the United States is evolving a steep wage tax, one that falls especially hard on the middle classes, at compressed rates.

B. *Death — to the Rescue?*

The payroll tax makes no effort to collect any tax on the yield to capital or from beneficent transfers. The income tax also ignores beneficent transfers to the transferee, and, although it is intended to fall on the yield to capital, the actual income-plus-realization tax is erratic at best in living up to its theoretical commitment. In large part for this reason, defenders of the idea that capital ought to bear some positive tax burden — that is, supporters of what the new understanding of tax refers to as the yield-to-capital norm — have long advocated other, supplemental taxes to "backstop" the income tax, specifically in regard to the yield to capital.[311] Chief among these addenda has been the gift and estate tax.

There has been much debate of late about the estate tax, whose supporters seem to be losing: EGTRRA, the 2001 tax act, gradually weakens the tax, then altogether repeals it for the single year 2010, then brings it back in full force.[312] Congress has repeatedly considered extending the repeal, to make the elimination of the tax permanent.[313] There is no need to rehash here the basic arguments over repeal, reform, or status quo. The main practical, descriptive point, for the new understanding of tax, is simply that the estate tax has been a very porous backstop to the income tax, indeed. The main theoretical, prescriptive point to see is that a gift and estate tax is not needed to

311. Most prominently, *see* Andrews, *Personal Income Tax*, *supra* note 8, at 1177-88; *see also*, Henry J. Aaron & Harvey Galper, *A Tax on Consumption, Gifts, and Bequests and Other Strategies for Reform*, *in* OPTIONS FOR TAX REFORM 106, 111-12 (Joseph A. Pechman, ed., 1984); Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499, 503-04 (2001); Harry L. Gutman, *Reforming Federal Wealth Transfer Taxation After ERTA*, 69 VA. L. REV. 1183, 1191 (1983) ("With a seriously eroded income tax base, a transfer tax . . . serves as a 'backstop' to the income tax by taxing the wealth that taxpayers accumulate through tax-preferred income sources.").

312. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 69 (2001).

313. *See* Edward J. McCaffery and Linda Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action* (draft on file with author) [hereinafter McCaffery & Cohen, *Gucci Gulch*]; Edward J. McCaffery, *A Look into the Future of Estate Tax Reform*, 105 TAX NOTES 997 (2004).

backstop a consistent, progressive postpaid consumption tax in the first place.

Although, as with capital taxes under the income tax, decedents' estates do pay some tax, the yield is consistently small.[314] Tax Planning 101, discussed above, provides a roadmap for readily avoiding the *estate* tax, by dying with net assets under its generous exemption level: spending it all and dying broke being the limiting case. This is morally problematic, because it is far from obvious that the spending of the rich is to be encouraged, or is any less harmful than their passing on of wealth — and shortly we shall see that Tax Planning 101 can be used to pass on wealth, as well, if the wealthy person so desires.

The use of Tax Planning 101 to avoid all federal taxes — the estate tax in particular by dying broke, or nearly so — shows once more that the deep problem with the status quo is not, as Andrews put it in 1974, with its inconsistent treatment of savings or accumulation. Rather it is with the use of capital transactions to finance consumption, tax-free. This allows a restatement of a central theme in the new understanding of tax: All capital is not the same, from the perspective of the quest for individuated justice in tax. What matters, morally, is the use that individuals make of their capital, not the source of the yield to capital. Andrews saw the "worst inequity, distortion, and complexity" in the income tax's treatment of accumulation, or savings. Not seeing — or not wanting to see, under the influence of Mill — any way to split the difference, to make distinctions among the uses of capital (as he had made among the uses of consumption in his 1972 article), Andrews recommended going all the way, to the total nontaxation of capital. Under the new understanding of tax, a surprising insight arises. What is problematic about the status quo — what is its "worst inequity" — is not the treatment of accumulation or savings, in and of itself; it is, rather, the inconsistent treatment of consumption, the other term on the right-hand side of the Haig-Simons identity. Through its structural problems, beginning — but not ending — with its inconsistent taxation of accumulation, the income-plus-realization tax allows the consumption of the wealthy to escape taxation altogether. The estate tax is not at all a "backstop" to this problem — of consumption financed by capital — because its mere existence encourages it. A potential taxpayer who has amassed or acquired significant portions of capital need not pay any further tax, whatsoever, within her lifetime, no matter what her lifestyle. This is problematic.

314. In 2004, the estate and gift taxes yielded only $25 billion, just over 1% of federal revenues. Office of Mgmt. & Budget, Historical Tables, Budget of the United States, Government, Fiscal Year 2006 [hereinafter Historical Tables], at 43-44 tbl. 2.5, *available at* http://whitehouse.gov/ (last visited Apr. 3, 2005). GEORGE COOPER, A VOLUNTARY TAX?: NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE (1979); McCaffery, *A Voluntary Tax?*, *supra* note 202; Martin Sullivan, *For Richest Americans, Two-Thirds of Wealth Escapes Estate Tax*, 87 TAX NOTES 328 (2003).

Still, one might support the estate tax within the context of a basic consumption tax — even a prepaid consumption tax — model, as ensuring that a tax gets levied at least once per generation.[315] (Another, different way to support an estate tax under a consumption tax model is as a corrective to the large accumulations of "private" capital that a consumption tax allows, and even encourages; Andrews followed this rationale,[316] and I shall address this argument later.) The idea is that wealth coming into an individual's possession — via labor market earnings or beneficent transfers — should be taxed once, and then all second taxes at the individual's level should be avoided, in the spirit of Mill. If such a system were to work, the pressure on the choice of prepaid versus postpaid consumption tax would lessen, because the greatest problems of socio-economic inequity tend to take place, as both Rawls and Robert Nozick, in their different ways, noticed, with a problem of iteration over time.[317] The more generations go by without the corrective of a tax, the more the unfairness compounds. But so long as each generation is taxed once — the estate tax serving as a proxy for an accessions tax, making sure that a tax is paid before the receipt of beneficent transfers — the problem of iteration is held in check. If the gift and estate tax worked as planned, it would put labor market and beneficent market returns on the same footing — taxed once each generation of beneficial users — with only capital market earnings free of taxation, the latter in accordance with Mill's principle.

The practical problem with this happy possibility is that the gift and estate tax does not work as planned. Even without further weakening — which seems all but certain to happen[318] — the estate tax is simply not a very effective mechanism for levying a tax on second or subsequent generations. It has too many holes, and of such a sort, as to make it inherently defective for the task. Consider the following two gaps.

One is the basic exemption amount, or so-called unified credit, now set at $1.5 million per person on death and $1 million for inter vivos gifts. A married couple, with proper planning, has $3 million — scheduled to rise to $7 million by 2009 and to infinity, at least briefly, in 2010 — to pass on death, altogether tax-free. The $1 million amount can be given by any person, at any time, to any other person, without

315. *See* Aaron & Galper, *supra* note 311.

316. *See, e.g.*, Andrews, *Personal Income Tax*, *supra* note 8.

317. *See* JOHN RAWLS, POLITICAL LIBERALISM (1993); RAWLS, *supra* note 52; ROBERT NOZICK, THE EXAMINED LIFE: PHILOSOPHICAL MEDITATIONS 28-33 (1989).

318. It seems highly unlikely that the exemption level, which is set to reach $3.5 million per person in 2009, will return to its pre-EGTRRA levels. Not only has the exemption level never been lowered in the history of the tax, but all current Senators, except for Russell Fiengold (D-WI), are on record as supporting at least a heightened exemption level. *See* McCaffery & Cohen, *Gucci Gulch*, *supra* note 313.

triggering a gift or estate tax.[319] Standard, sophisticated estate planning allows a basic leveraging of the value, as by placing assets in a family limited partnership form.[320] Wealthy parents with two children can transfer up to $2 million of prediscounted property to each child, altogether tax-free, and the children — or their financial advisers — can play the Tax Planning 101 game to their heart's content. If the wealth is transferred when the parents are 50 years old, and invested at an 8 percent rate of return, it will grow to being worth over $20 million per child by the time the parents reach 80.

In addition to this unified credit or exemption amount, there is a second hole, the "annual exclusion amount," presently set at $11,000.[321] This is a per-donor, per-donee, per-year amount that can be given altogether tax-free. Once again, standard, sophisticated estate planning allows the values to be doubled, with two parents, and perhaps quadrupled, with fractional share discounts. Two parents can give each of their children $30,000 or more worth of value each year — altogether apart from the exemption amount, just discussed, and also not including qualified medical and tuition expenses[322] — tax-free. A pattern of such annual giving, begun at birth, can easily result in each child having $8 million, tax-free, at her fortieth birthday — a good stake for playing the Artful Dodger's game.[323] Skillful use of perfectly legitimate estate-tax planning advice can get tens or even hundreds of millions of dollars out of one's estate, tax-free. So much for the once-per-generation norm.

These problems with the estate tax follow from its structure; it is a back-ended wealth tax, typically imposed when someone dies, on the wealth she has left over on her deathbed. But death is a difficult time to tax. Given the incentives generated by the tax's high marginal rate structure, wealthy patrons can and do plan ahead to avoid it, making it the original "voluntary tax."[324] Tax Planning 101 combines with Estate Planning 101 — give early, often, and in trust[325] — to eviscerate the tax. It is a mistake to think that Tax Planning 101 need be practiced by narrowly selfish individuals. While dying broke is the simplest and

319. EGTRRA keeps the gift tax exemption level at $1 million per person, so the higher numbers in later years refer only to the estate tax, as things now stand.

320. Sullivan, *supra* note 314, at 332. *But see* Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (2003) (casting family limited partnership technique into some question).

321. I.R.C. § 2503 (2004).

322. *Id.*; MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 68-74; INTERNAL REVENUE SERV., PUB. NO. 950, INTRODUCTION TO ESTATE AND GIFT TAXES 4-5 (2004), *at* http://www.irs.gov/publications/p950/index.html (last revised Sept. 2004).

323. At a 5% annuity rate, this sum can generate $400,000, tax-free, every year, for life.

324. *See* COOPER, *supra* note 314; McCaffery, *A Voluntary Tax?*, *supra* note 202.

325. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 68-73 (discussing "Estate Planning 101" and other techniques for avoiding or minimizing estate taxes).

surest way to avoid the estate tax, the borrowing in buy/borrow/die can be used to transfer wealth down to the next generation, as well. In such a case, there is no tax at all in the second (or later) generation(s). The problems of iteration can become severe. A dramatic illustration of the stakes and problems has been the recent trend, initiated by estate-planning practitioners, to have states repeal the hallowed Rule against Perpetuities, so as to allow wealthy benefactors to set up "dynastic" — that is, potentially infinitely lived — trusts.[326]

As it has been argued in the past, it still may be argued that an estate tax, with all of its holes, is better than nothing. This is parallel to the consequentialist objection to income tax reform, considered above: the income tax may be rather ineffective at getting at capital, but at least it tries, and so we ought to retain it in the name of fairness. The support for the estate tax similarly follows from the implicit acceptance of the yield-to-capital norm: any taxes that get at capital are better than nothing. Within the traditional view, a consumption tax is the "nothing" in this choice set because it does not get at the yield to capital at all, and so advocates of the yield-to-capital norm cling to whatever is left of the income and estate taxes.

Fortunately, we do not have to face the choice of an ineffective estate tax or nothing. The new understanding of tax changes things. When we get the fair timing of tax down right, we see that there is a better way — and a better time — to tax than either the moment of initial earnings or the time of ultimate death.

C. *Corporate Taxes Too*

The corporate income tax, like the gift and estate tax, has been defended as an important "backstop" to the personal income tax.[327] The argument is that the corporate income tax gets at wealth that is left in the corporation — a tendency aggravated by *Macomber* — and so cuts against the deferral of the realization requirement. The desire to have a backstop to the basic income tax reflects the normative commitment to taxing capital and its yield, and an understanding that the actual income tax falls far short of implementing this goal. Yet, even less so than the gift and estate tax, the corporate income tax is not a satisfactory backstop to the income tax.

326. *See, e.g.*, Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303 (2003); Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 CARDOZO L. REV. 2097 (2003).

327. *See*, *e.g.*, Kim Brooks, *Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax*, 36 U.B.C.L. REV. 621, 672 n.51 (2003); *but cf.* Roger H. Gordon & Jeffrey K. Mackie-Mason, *"Why Is There Corporate Taxation in a Small Open Economy? The Role of Transfer Pricing and Income Shifting," in* THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS, 67 at 88 (Martin Feldstein, James R. Hines, Jr., & R. Glenn Hubbard, eds., 1995) (corporate tax is a backstop to tax on labor, not capital, income).

To start with, like the gift and estate tax, the corporate income tax is porous and avoidable.[328] But there is a much deeper problem with the corporate income tax. It is the problem of incidence — of who, really, ultimately bears the burden of the tax. Corporations are legal fictions; only real people pay real taxes. Thus the dollars remitted to the government on account of corporate taxes must come out of someone's pockets, somewhere along the line. There is a great deal of uncertainty on this matter among sophisticated public finance economists. There are two broad candidates for ultimate payors, and each is problematic in terms of the fairness of tax. Some models suggest that some or all of the real burden of the corporate tax falls on wages or consumption, adding to — not counterbalancing — the general bias of the status quo, towards a prepaid consumption tax.[329] The corporate tax becomes a wage tax in drag. Other models suggest that some or all of the corporate tax falls on capital. This burden on capital cannot be specific, however, as in a naive partial equilibrium model; it cannot be the case that the particular owners of particular corporations see the corporate income tax come out of their pockets. Capital is capital, and it seeks a competitive rate of return. Thus, pricing or capitalization effects equilibrate the markets after the corporate tax falls, so that all capital bears a competitive after-tax rate of return. In other words, the incidence of the corporate income tax, to the extent it falls on capital at all, must be felt rather generally in all accessible capital markets.[330]

In this very generality lies a problem. Those who see the corporate income tax as an important "backstop" to the income tax see it as an important tax on capital. Yet the new understanding of tax has shown us that we do not want to tax all capital, all the time. This leads to a particular critique of the corporate tax: to the extent it falls on capital at all, it is not an individuated tax — it fails Vickrey's (and our) test for progression. The burden on capital makes it just as hard to engage

328. The avoidance is partly due to the prevalence of corporate tax shelters. *See generally*, Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2001); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. Rev. 209 (2001); Lawrence Zelenak, *Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. REV. 177 (2001). But the overall yield from the tax has dropped fairly steadily over many decades, from a high of 7.2% of GDP in 1945, to 4.2% as late as 1967, to 1.6% in 2004. *See* HISTORICAL TABLES, *supra* note 314, 33-34 tbl.2.3.

329. Arnold Harberger, an early advocate of the view that some or all of the burden is borne by capital, now feels it is mostly borne by labor. *See* Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962) (the seminal piece); Arnold C. Harberger, *Monetary and Fiscal Policy for Equitable Economic Growth*, *in* INCOME DISTRIBUTION AND HIGH-QUALITY GROWTH 203 (Vito Tanzi & Ke-young Chu eds., 1998) [hereinafter Harberger, *Monetary and Fiscal Policy*]. *See also* Gordon & Mackie-Mason, *supra* note 327 (incidence on labor, given small open economy (as in Canada)).

330. *See* Harberger, *Monetary and Fiscal Policy*, *supra* note 329.

in the kind of ordinary-savings or smoothing transactions that ordinary moral intuitions favor, as well as in the kind of elevating, shifting transactions that these intuitions want to reach — it does not split the ordinary-savings and yield-to-capital norms. The corporate income tax also does not make any differentiation based on the level of the beneficial owner's income, consumption, or wealth; it is a crude one-size-fits all tax, a flat tax in essence, like the current capital gains or corporate dividend tax.

If corporate taxes are to be justified, it must turn on the political economy, or the psychological political economy, of hidden taxes,[331] and not on the principled taxation of capital. Corporate taxes are simply far too crude a mechanism to effect individuated fairness in getting at the yield to capital or anything else.

D. *State and Local Taxes*

Roughly one-third of all taxes in America are collected at the state and local levels.[332] These, too, ought to play a role in any general theory about the fairness of tax.

The three largest state and local taxes are sales (36 percent of total), property (29 percent) and income (27 percent) taxes.[333]

At first glance, sales taxes are paradigmatic of the postpaid consumption tax. But here is a place where the traditional view of tax still holds. Because state and local sales taxes are *flat* taxes, they are indeed equivalent to wage, or yield-exempt, taxes under the traditional view, as Ant and Grasshopper helped us to see. The reason to care about the new understanding of tax is to preserve and, indeed, strengthen the tax system's commitment to progressivity in effective tax burdens. State and local sales taxes more or less moot the point.

The remaining state and local taxes do not offer much of an antidote to what is happening on the federal side. State and local income taxes tend to simply, and by rote, track the federal income tax, and thus contain all of the holes in the commitment to taxing savings we have been exploring. This leaves state and local property taxes, which do indeed effect some degree of progressivity, being based on

331. Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995); McCaffery, *Cognitive Theory and Tax*, *supra* note 43, at 1874-86.

332. In 1999, state and local governments collected approximately $816 billion in taxes, U.S. DEP'T OF COMMERCE, *supra* note 308, at 272, whereas the federal government collected approximately $1.828 trillion. *Id*. at 308 tbl.454. Of the $2.644 trillion total, state and local taxes accounted for just over 30 percent.

333. *Id*. at 272. The figures for income taxes seem to include corporate as well as individual taxes, and therefore overstate the effect of the latter. *Compare id.* at 272, *with id*. at 270.

the assessed value (or initial purchase price)[334] of real or personal property. But real property taxes, by far the major part of property taxes, tend to finance local public goods,[335] and often get "capitalized" into the values of homes. Without even factoring in the income tax deductibility of these payments, the equities of state and local property taxes are rather crude, at best.

E. *Summing Up: A Voluntary Tax*

Add together the so-called income tax, considered in the last Part, and the panoply of taxes considered in this Part, and this is what we have in America in the early years of the twenty-first century: a highly burdensome wage tax at compressed tax rates. The major tax is the federal personal income tax, but this is increasingly equivalent to a prepaid consumption or wage tax, at historically and relatively (since World War I) flat rates. The payroll tax is by far the second biggest tax in the landscape, and it does not even pretend to be anything other than a rather flat, even regressive wage tax. State and local taxes scarcely even try to posit a counter trend, and indeed tend to rely on flat sales taxes that feature yield exemption. The two federal taxes that aim at capital — the gift and estate and corporate income taxes — are scattershot affairs at best, small in their magnitude, fairly easily avoided, and in any event crude in their ultimate equities.

In sum: taxes on beneficent transfers scarcely exist. Taxes on capital are easily avoided and virtually voluntary. Taxes on wages are high and inescapable. This is where we have come, guided by the traditional understanding of tax. Where to, next?

VII. THE FAIR TIMING OF TAX

Traditional tax policy endlessly debates between the income and consumption taxes, mistakenly equating both forms of consumption taxes, which it sees as exempting the yield to capital — or, sometimes, falling arbitrarily on it — by design and on principle. Under the traditional view, the only hope to satisfy both an ideological and an ordinary moral intuition to tax the yield to capital is to cling to an income tax. While one can blame special interest politics or other ills

334. This is the case, for example, in California, under Proposition 13. CAL. CONST. art. XIIIA, §§ 1-6.

335. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). For discussions of Tiebout, see Bruce W. Hamilton, *A Review: Is the Property Tax a Benefit Tax?*, *in* LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS 85, 90-92 (George R. Zodrow ed., 1983); George R. Zodrow & Peter Mieszkowski, *The Incidence of the Property Tax: The Benefit View Versus the New View*, *in* LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS, *supra*, at 109.

for the failure of the current tax system to address its many gaps, another culprit lies close at hand, like Poe's purloined letter: theory, and most importantly, the traditional view of tax itself.

When we take a closer look at the analytic muddle of tax, we understand that we do not have, have never had, and will never have a pure income tax, largely for the reason that we do not want one. What we have is a mishmash of income and consumption tax elements.

The traditional view of tax would have us be forever doomed to some such uneasy compromise. For we are, it would seem, of two minds when it comes to the taxation of savings. With one mind, we want to tax the yield to capital, and hence we cling to the forms of income, corporate income, and gift and estate taxes. But with the other mind, we do not want to tax savings, and hence we riddle the so-called income tax with exclusions and deductions, and lack the will to strengthen the structural flaws applying to the taxation of the yield to capital.

The new understanding of tax liberates our minds from the grip of theoretical incoherence that dooms the present practice of tax. Normative reflection first identifies and then reconciles the ordinary-savings and yield-to-capital norms. It turns out, *mirabile dictu*, that the people are of one, not two, minds — with two norms, not one — when it comes to the taxation of capital and its yield. It seems fair and appropriate to burden capital transactions when these facilitate or enable a better lifestyle, reflecting a greater "ability to pay" or more "benefits received" from the social compact. But it does not seem fair and appropriate to burden capital transactions when they are used simply and sensibly to move around in time uneven labor market earnings. These are ordinary moral intuitions that theory can easily accept, in a Rawlsian reflective equilibrium. The new understanding of tax shows us, analytically, that a consistent progressive postpaid consumption tax implements these two norms by design, simply, and at the same time.

All that remains, though it has been anticipated, is a normative argument, that this *is* should become an *ought*, and the clearing up of some final loose ends. Those are the aims of this final Part.

A. *A Better, If Less Sophisticated, Argument*

Andrews's "best, most sophisticated argument" for a consumption tax tracked Mill's earlier observation about double taxation, which in turn had roots as far back as Hobbes.[336] Andrews's was primarily a horizontal equity argument, about preserving the pretax equality between present and deferred consumption, between spenders and

336. *See* Andrews, *Personal Income Tax*, *supra* note 8; MILL, *supra* note 1, at 814; HOBBES, *supra* note 57, at 386-87; Fried, *supra* note 7.

savers, Ant and Grasshopper. Mill had elegantly made the point at a time when taxes were few and rates were low.

A century and a half after Mill, things have changed. We have a better understanding of capital markets. More importantly, tax has expanded greatly in scope, and high tax rates — certainly compared to any Mill himself contemplated — are here to stay. These changes ought to lead to a rethinking of the grounds for consumption tax. Under progressive marginal rates, a postpaid consumption tax does not feature yield exemption by design. Nor does such a tax operate randomly. Capital market transactions that elevate lifestyles bear a higher burden of tax; those that smooth or diminish lifestyles lower the burden. This pattern of effect on the yield to capital is not a reason to abandon postpaid consumption taxation or progressive rates. Far from it: on the better understanding of tax, it gives a reason to support each. It is the argument structure for a consumption tax, of the right sort, that needs repair. A progressive postpaid consumption tax need not preserve the pretax equality of savers and spenders, and need not increase savings or the aggregate capital stock at all. The tax needs a better if less sophisticated argument to justify it. Fortunately, this lies at hand, in common sense and ordinary moral intuition.

The answer lies not far from asking the right question: the question of the fair timing of tax. Under the new understanding of tax, the great divide is between taxes on inflows and taxes on outflows. The income and the prepaid consumption taxes stand together on one side of this divide, opposed by the postpaid consumption tax. Prepaid consumption and income taxes each make their decisions about the fair burden of tax at the time of inflow into a household; the difference is that an income tax includes capital market yields (as well as, possibly, beneficent transfers[337]), whereas the prepaid consumption tax includes labor market earnings alone. But as Figures 1-6 illustrated, and common sense confirms, the pattern of inflows is, from a moral point of view, arbitrary. Predicating progressivity on inflows means that one's effective tax burden turns on matters of luck and whim vis-à-vis the timing of inflows. This affects choices of life plans — it discriminates based on patterns of study, work, and leisure, having little or nothing to do with command over material resources, ability to pay, or benefits received. At the same time, the income tax constrains the progressivity in the design of the tax system, the very thing an individuated tax system ought to be facilitating. Progressive

337. Douglas A. Kahn & Jeffrey H. Kahn, "*Gifts, Gafts, and Gefts" — The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441 (2003).

wage taxes can only be avoided by not working, which imposes a cost to the wider society without apparent benefit.[338] There is no way out.

A consistent progressive postpaid consumption tax, in contrast, makes its decisions about the appropriate degree of progressivity at the right — fair — time.[339] It falls on outflows, or spending. Such a tax favors (or does not disfavor) capital smoothing transactions, but imposes a tax — in the form of the higher effective progressive rates — on lifestyle enhancing or capital upward shifting transactions. There is luck in what happens in capital markets — as there is luck, too, in labor market earnings and beneficence[340] — but, importantly, this is luck that relates to the very reasons for deciding on the appropriate burden of taxation, luck that goes to command over material resources, ability to pay, and benefits received. It is not the morally insignificant luck over the timing of the receipt of material resources; it is the morally significant luck that goes to the extent of one's total control over such material resources.

A consistent postpaid consumption tax is source neutral in an appealing sense; it falls equally on labor market, capital market, and beneficent transfers, provided that they are used to elevate a taxpayer's lifestyle. It does not matter what, exactly, supports an individual's standard of living. All that matters is that something did. Hence, the animating norm of the tax is solidly a vertical equity one, looking to a consistent, meaningful, observable, and comparable measure of interpersonal well being. Among many other practical virtues, the tax can finesse questions of the precise source of wealth or income — whether it was derived from labor, capital, or beneficence. This is a significant improvement on the status quo, in both theory and practice. Within lifetimes, much effort today goes into dressing up labor earnings in capital clothing, such as through the use of stock options. A consistent postpaid consumption tax does not mark the distinction. Across lifetimes, wealth can be transferred either by financial and physical capital, or by human capital — the children of the wealthy tend to get better (more expensive) educations, better

338. I have speculated elsewhere that a society that wished to reduce its citizens' working hours might indeed welcome such an incentive. *See* McCaffery, *Being the Best*, *supra* note 15, at 623. But this does not strike me as a compelling reading of contemporary American norms.

339. As I have put the matter in a different context: "Our current tax system taxes people when they work, when they save, when they marry, when they give, and when they die. These are wrong choices, all. We should tax people when and only when they spend." Edward J. McCaffery, *Tax Reform to Die For*, WALL ST. J., Nov. 21, 2003, at A12.

340. *See* RAWLS, *supra* note 52, at 7, 326 ("natural lottery" distributes talents and abilities, while society's "basic structure" determines income, social standing and the like).

networks, more job connections, and so forth.[341] The current regime, imposing a porous income-plus-estate tax, scarcely hits at intergenerational transfers of financial capital, although it does capture human capital ones, by wage taxation at the child's level. The postpaid consumption tax once again does not mark the distinctions. Financially privileged lives are taxed, on account of the privilege, however financed.[342] The practical virtues coincide with a moral, theoretical appeal.

At the same time, a consistent progressive postpaid consumption tax implements the other norm of capital, the ordinary-savings one. Capital transactions that smooth lifestyles, within or between generations, lower the aggregate burden of taxation.

For the most part, taxpayers do smooth. But a consistent, progressive postpaid consumption tax as I have described it (that is, without a mechanism such as Vickrey's cumulative lifetime averaging to modify or define it)[343] determines its level of progressivity on the basis of taxpayer's actual consumption patterns, whether taxpayers have smoothed or not. Just as such a tax system allows taxpayers to lower the burden of taxation by smoothing, it penalizes them, at the margin, for not smoothing. What is morally compelling about one's spending level, in general, and, in particular, about average annual labor market earnings in constant dollar terms? A consistent, progressive postpaid consumption tax makes its decisions of the appropriate level of taxation on the basis of the former, and allows capital transactions that effectuate the smoothing to the latter to lower the burden of taxes. Why?

First, spending, as already suggested, reflects a fair and objectively observable measure of a taxpayer's standard of living, command over material resources, ability to pay, and benefits received. Spending turns on importantly voluntary, autonomous decisions, as Adam Smith suggested, rather than the impersonal, external factors that affect the timing of inflows.[344]

Second, and related, capital transactions that smooth uneven labor market earnings do not reflect greater ability to pay, benefits received, or command over resources. They are simply the means by which one

341. *See* John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV. 722 (1988) (explaining that wealth transmission has changed from land to human capital in the 20th century).

342. In this regard, a consistent, progressive postpaid consumption tax operates as a better, more practical "privilege tax" than the specifically designated tax discussed by ACKERMAN & ALSTOTT, *supra* note 103.

343. *See* Vickrey, *supra* note 188.

344. SMITH, *supra* note 54, at 777-78, quoted in note 57, *supra*. I have discussed the voluntariness of spending in McCaffery, *Cognitive Theory and Tax*, *supra* note 43; McCaffery, *A Voluntary Tax?*, *supra* note 202; Edward J. McCaffery, *Why People Play Lotteries and Why it Matters*, 1994 WIS. L. REV. 71.

finances her lifestyle through time, dealing with the particular patterns of human and financial capital realizations. Using a smoothed consumption line as an analytic baseline allows us to see two effects of a consistently progressive postpaid consumption tax in its interaction with capital market transactions. First, taxpayers who fail to perfectly smooth consumption can pay a price for their uneven spending profile; this was the "paternalistic push" of the system, noted above[345] (though, again, it can be eliminated through cumulative averaging within the postpaid consumption tax system). But, second, and much more important, taxpayers who can do better, in material terms, than their average annual labor market earnings will see the value that enables them to do so — whether from capital market or beneficent transactions — taxed at a higher rate. If the combined present value of one's lifetime annual consumption exceeds that of one's aggregate lifetime earnings, something has happened to allow the taxpayer to elevate herself in material consumption terms. The smoothed consumption line accepts the best lights reading of Mill's argument against "double" taxation, and Andrews's case for preservation of the pretax equality of savers and spenders, while at the very same time conceding the most powerful criticism of these positions made by Warren and others, namely that those who receive a return to capital are better off, in terms of their command over material resources, than those who do not. If capital has made one richer, viewed in a wide lens of time, the yield-to-capital norm (and vertical equity generally) demands that we tax the yield; if capital transactions have merely moved resources around in time, the ordinary-savings norm (and horizontal equity generally) demands that we not burden its yield. The smoothed consumption line, as a baseline for choosing the level of progressivity imposed, is a principle imperfectly reflected in our present practices, most importantly in regard to retirement savings.

The bottom line, normatively, is what strikes us all as fair.[346] A prepaid consumption tax — like the current "income" tax — makes its judgments on the appropriate level to tax on the basis of labor earnings alone. It would ignore all the sources of enhanced lifestyle from capital markets or beneficent transfers and penalize those with temporally uneven labor market earnings. A progressive postpaid consumption tax makes its decisions about the appropriate level of taxation on the basis of outflows. This means that capital transactions that smooth out uneven labor market earnings will lower the burden of taxation; both capital market and beneficent transactions that finance greater lifestyles than one's own earnings would allow raise the burden.

345. *See supra* Part IV.E.

346. *See* McCaffery, *Being the Best*, *supra* note 15*; see also* Warren, *supra* note 13, at 946.

The best, most sophisticated argument for a consumption tax of the right sort — a progressive postpaid consumption tax — is that this tax makes its judgments about the appropriate level of taxation at the right time, allowing for a fairer, more enduring degree of progression in tax burdens in both theory and in practice, and differentiating between savings and investment activities that simply move around labor earnings in time and those that facilitate greater levels of consumption, alone among major comprehensive tax options. This is not as neat and elegant an argument as Andrews's "most sophisticated" one. It does not pivot on any simple, handy turn of phrase. But it is a better argument. It connects the fairness of the tax base question — income versus consumption, of both forms — to the issue of progressivity by means of the fair timing of tax. It thus not only reconciles the two appealing norms about the taxation of savings — the ordinary-savings and yield-to-capital norms — but it also allows for a better, fairer, more meaningful and enduring progressivity in tax burdens. This is true both internal to the tax system or base in question, and external to them. Internally, a consistent, progressive postpaid consumption tax tethers its decisions on the appropriate level of taxation to the objective, observable, meaningful variable of personal spending. Externally — as a matter of tax system design — a postpaid consumption tax importantly allows for more progressivity in tax burdens.[347]

347. I have simply posited this point throughout. It follows from my intuition that deterring high-end spending is more reasonable than deterring high-wage labor earnings. To some extent, this is simply a moral argument. *See* McCaffery, *The Right to Waste?*, *supra* note 24, McCaffery, *Uneasy Case*, *supra* note 165. For the empirical consequences, under a consistent, progressive postpaid consumption tax, we need to rethink the analysis of optimal taxation. It is not optimal *income* tax that we should model, but optimal *postpaid consumption* taxes. Of course, for most Americans, living from paycheck to paycheck, the two converge because income equals consumption for those who do not save. And in all cases, the social-welfare maximizer will still be concerned with the elasticity of labor, a productive input. But under a consistent postpaid consumption tax, the nature of this input ought to change. High marginal tax rates on high-end consumption need not deter labor efforts, as opposed to spending decisions. Such taxes will deter those who earn only to spend on themselves — such people will rationally backward induce, and stop working today — but they need not deter those building up wealth for other reasons, including intergenerational altruism (yet another reason not to engraft a wealth transfer tax onto a consistent postpaid consumption tax model, or to choose Vickrey's cumulative lifetime income averaging over a cumulative lifetime consumption averaging or the simpler general tax outlined here). To the extent the behavioral response to progressive spending taxes is to save, this can be a public good. The questions are technical, empirical ones, beyond the scope of the present effort. But they hold out an intriguing possibility — the very spirit behind the project of ascertaining the fair timing of tax. If we get the form of tax right — its timing and its base — we can, at long last, get its redistributive functions down right. The embarrassments of today point us to hope for a better tomorrow. I thank Kirk Stark for pressing these thoughts on me.

B. *Transitions, Implementation, and Objections*

This Article has mainly been concerned to advance the new understanding of tax. I have addressed many of the practical issues of transitions to and implementation of a progressive postpaid consumption tax elsewhere, as well as noted the most frequent objections to the practical proposal.[348] This section simply quickly canvasses some important themes, in the interest of at least noting them.

1. *Implementation*

As Andrews set out perfectly well in his 1974 and subsequent articles, a postpaid consumption tax is not difficult to implement. In particular, a consistent postpaid consumption tax does not entail adding up all the particular items of consumption. Rather it rests on the simple elegance of the Haig-Simons definition of Income, Equation [1] above. If *Income* equals *Consumption* plus *Savings* ($I = C + S$), then *Consumption* equals *Income* minus *Savings* ($C = I - S$). All that is needed to implement a consistent progressive postpaid consumption tax is to systematically subtract savings from "income," measured just as we do today. This means, of course, adding in dissavings — including debt, to which we turn in a moment.

There are hard cases, of course, of defining "consumption," but most of these already exist under the income tax (which after all includes consumption in its base, as well, as the Haig-Simons definition shows). The simplest way to get from the current system to a consistent postpaid consumption tax model is to repeal all limits on traditional IRA plans, and include debt as taxable "income." Then one could repeal preferential rates for capital gains and all rules for the "basis" of investment assets.

2. *The Role of Other Taxes*

One considerable practical advantage of a consistent, progressive postpaid consumption tax is that it at least lessens the need for both gift and estate and corporate income taxes. These taxes have been perhaps best justified as being important "backstops" to the actual income tax's flawed instantiation of the income ideal. Both taxes reflect a desire to get at some capital; the gift and estate tax might also reflect a norm to tax at least extraordinary, large amounts of beneficence. Under the traditional view of tax, the gift and estate tax in particular is often thought to be important in any movement towards a consumption ideal. This is either because a consumption tax

348. *See* MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 117-60.

enables second and later generations to live off the fruits of a prior generation's capital, altogether untaxed, or because a consumption tax facilitates the building up of large stocks of private capital, as Andrews maintained.

Under the new understanding of tax, things change. A consistent, progressive postpaid consumption tax does fall on the yield to capital, under the right circumstances, and at a compelling time. Such a tax is also individuated, meeting Vickrey's test. Second and later generations are taxed at the moment of expenditures, and the tax burden on the family will have increased if these descendants are in fact consuming at a higher level than their ancestors. Arguably, this incentive to redistribute wealth within extended families is a welfare-improving one.[349] In any event — and this is important — a consistent postpaid consumption tax would impose a far greater, far more systematic and principled burden on inherited wealth than what obtains today, under the flawed income-plus-estate tax regime. As things now stand, under the effective prepaid consumption tax model, *both* present *and* future generations living off the yield to capital need pay no tax. Relatedly, I shall consider below the theoretical issues involved with large stocks of private capital, which a postpaid consumption tax might be thought to make more likely and prevalent.[350] But it is again worth pointing out, however, both that such large stores of capital can and do easily arise today, under the essentially "voluntary" tax on capital imposed by the income tax, and that stocks of private capital might well decrease under a conversion to a consistent postpaid consumption tax, because under it — unlike the status quo — consumption financed by capital will bear a positive burden of tax.

A compelling case can be made, then, to replace the current income, corporate income, and gift and estate taxes with a consistent postpaid progressive consumption tax — and all to get at the yield to capital in a better, fairer, more individuated and progressive way. Such a tax consistently taxes people, including heirs, when they spend, not when they work or save. Aside from consistency, this principle comports with ordinary moral intuitions about fairness in tax. Still, justice might be thought to require some additional tax on inherited wealth, as a freestanding matter,[351] either at the level of the transferor or in the hands of the transferee. It is worth noting, as a practical matter, that the latter might be effected by allowing earned-income

349. *See* Kaplow, *supra* note 172; s*ee also* McCaffery, *Uneasy Case*, *supra* note 165, at 319 (citing Joseph E. Stiglitz, *Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence*, 86 J. Pol. Econ. S137, S146-49 (1978)).

350. Andrews thought so. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1118-19.

351. *Cf.* Rawls, *supra* note 52.

allowances under the postpaid consumption tax, in effect isolating out those who live solely off of financial capital for higher tax burdens.[352] This adds complexity to the simpler proposal for a consistent, progressive postpaid consumption tax, and is perhaps inconsistent with its best spirit, but it can be done. Similarly, untethered from the idea that an estate tax is somehow needed to "save" the income tax, with its realization requirement and all, a wealth or wealth transfer tax, with broader bases and a much reduced rate structure, can isolate out some of the perceived harms of transferred wealth without the steep distortions of the status quo.

Still, much of the normative attraction of the new understanding of tax rests on its more compelling instantiation of a source-neutrality norm. Persons with high salaries are benefited in many ways, by the natural lottery of their talents, education, connections, luck, and so on. A consistent, progressive postpaid consumption tax does not differentiate between and among sources of good fortune — own or other's labor market earnings, own or other's capital market yields. All that matters is how one lives in material terms. That is a fairly simple and compelling norm to implement.

3. *The New Achilles Heel*

To Andrews, and within the traditional view of tax, the realization requirement of *Macomber* was the Achilles heel of the income tax. And so it is, from the perspective of an ideal income tax. The realization requirement is the first and most important step in converting the so-called income tax into a wage tax. But from the vantage point of a consistent, postpaid consumption tax, the realization requirement gets it right: there is no need to tax until and unless savings or investments are cashed out and consumed on private preclusive use.

Under the new understanding of tax, however, a new Achilles heel arises: the tax treatment of debt.[353] It is the "borrow" part of Tax Planning 101's buy/borrow/die that is problematic. This is the step that allows *consumption* to escape tax-free.

The point is especially important because it is so poorly understood. Thus the USA Tax, the practical variant of a postpaid consumption tax that received serious legislative consideration in the mid 1990s, tragically neglected to include debt in its base.[354]

352. *Cf.* Andrews, *Personal Income Tax*, *supra* note 8; McCaffery, *Uneasy Case*, *supra* note 165.

353. *Compare* Calvin Johnson, *What's a Tax Shelter?*, 68 TAX NOTES 879 (1995) (arguing that the prevalence of tax shelters arises out of the treatment of debt), *with* Hime, *supra* note 185 (analyzing the problem with current tax law treatment of debt).

354. *See* SEIDMAN, *supra* note 88; McCaffery, *Tyranny*, *supra* note 192.

Theoretically, the treatment of debt is essential to the fair timing of tax and to providing symmetry to the taxation of capital market transactions by allowing forward as well as backward smoothing, in the manner of Figure 2. Practically, any postpaid consumption tax that does not include debt in its base is doomed to failure, on account of the ease of the arbitrage to avoid it.

Hence it is imperative that any real-world postpaid consumption tax tackle the issue of debt. This is the single biggest practical challenge facing the tax. Other perceived obstacles, such as the problem of "pre-enactment basis," consumer durables, housing, and so on tend to be overstated.[355] The proper treatment of debt is essential to getting tax right.

4. *Capital as Power*

This section picks up an important and long-bracketed issue. The capital norms central to the new understanding of tax are norms about cash flow — they are about how to account for and tax the yield to capital as it comes into and out of a household or a taxpayer's control. But capital has another dimension as well: its mere presence and the power and pleasure that this presence brings.[356] What should the tax system do about the stock of wealth? It was this concern that led Andrews to recommend adding on a gift and estate tax to a consistent postpaid consumption tax, out of worries that private accumulation would grow unbearably great under a consistent consumption tax.[357]

There are compelling reasons, of both a nonideal and an ideal nature, why this concern against a consistent progressive postpaid consumption tax is misplaced, and that in fact such a tax can adequately meet all of society's reasonable concerns over the private capital stock.[358] But it is also important to see that these are, indeed,

355. Preenactment basis is "[t]he basis in an asset held prior to the start of a new tax system." MCCAFFERY, FAIR NOT FLAT, *supra* note 2, at 164. For discussion of the preenactment basis of assets in the move from the current "income" tax to a consumption tax, see Louis Kaplow, *Recovery of Pre-Enactment Basis under a Consumption Tax: The USA Tax System*, 68 TAX NOTES 1109 (1995).

356. *See* MURPHY & NAGEL, *supra* note 6, at 114 ("It should be obvious that wealth is an independent source of welfare, quite apart from the fact that some of it may be consumed later.") I have long argued against the relevance of this fact to tax policy. *See* McCaffery, *Uneasy Case*, *supra* note 165; McCaffery, *Political Liberal Case*, *supra* note 197. More recently, Weisbach & Bankman, *supra* note 7, have made similar criticisms.

357. *See* Andrews, *Personal Income Tax*, *supra* note 8, at 1169-70.

358. I first pressed these arguments in 1994. *See* McCaffery, *Political Liberal Case*, *supra* note 197; McCaffery, *Uneasy Case*, *supra* note 165. I attempted to revise them again in 1996. *See* McCaffery, *Being the Best*, *supra* note 15. I now realize that this argument should not derail the case against comprehensive tax reform; a separate argument can be had out over wealth taxes, which can as easily accompany a so-called income as a postpaid (or, for that matter, prepaid) consumption tax.

logically distinct arguments. A tax on, or regulation of, private stocks of capital, at some quanta or in some cases, can accompany any comprehensive tax plan — income, or prepaid or postpaid consumption. This is an argument worth having out, but it need not derail the larger debate over comprehensive tax system design.[359]

The practical arguments begin with the fact that the present income tax is not working well, at all, to monitor the situation of private stocks of wealth. The new understanding of tax gives a precise reason to understand why this is so: the current system is largely a prepaid consumption or wage tax that makes little serious attempt to fall on capital or its yield. It is therefore a mistake to consider that private stocks of capital will necessarily increase under any conversion to a consistent, progressive postpaid consumption tax. Such a tax will have two large and important base-broadening features. First, there will no longer be any need for special capital gains rates, or lower rates on corporate dividends and the like. Wealth that is consumed will all be taxed under a uniform rate schedule, just as now obtains, for example, for withdrawals from traditional IRAs and 401(k) plans. Second, consumption that is financed by debt backed by capital will now bear a tax. I have no ready way of quantifying the magnitude of this effect, but I suspect it to be large.[360] Finally, the rate structure can also increase in its slope under a consistent postpaid consumption tax. One of the animating goals of getting the fair timing of tax down right is to increase the level of progressivity in the tax system, reversing a seemingly irreversible trend under the status quo, witnessed over a half century of tax policy changes. Spending can be taxed in a more steeply sloped fashion than can wages.

These practical advantages of a postpaid consumption tax over the status quo add to the practical difficulties with any separate wealth tax, one that would apply to stocks of capital alone. Such taxes encourage consumption, of course, which seems inconsistent with the spirit of a consumption tax, but the new understanding of tax helps to show that things are not so simple. A consistent, progressive postpaid consumption tax is a tax on capital in important cases, after all. But taxes on static sources of wealth are problematic, difficult, and costly. Postpaid taxes on cash flows are far simpler to implement.

None of these practical, nonideal concerns would carry much weight, however, if theory suggested a large and persistent problem with private stocks of capital. As I have suggested, this is not a concern that ought either to favor the status quo, or to prevent a conversion to a more principled and progressive postpaid consumption tax. Further,

359. Rakowski, *supra* note 15; Shakow & Shuldiner, *supra* note 77; Shaviro, *supra* note 103.

360. I thank Bill Gale for related discussions.

even in the domain of theory, there are reasons to believe that the concern over capital as power is mistaken. A consistent, postpaid consumption tax already chills the use of "private" capital to fund private preclusive use at any point in the future, through its tax rate mechanism: the future tax operates as a present lien against potential consumption. Tax rates can — and I believe should — increase under the more principled tax system design. The further use of private capital to achieve private benefit can be affected far more by the regulation of private capital than by its taxation. A consistent postpaid consumption tax provides a mechanism to regulate wealth. As I have written elsewhere, a postpaid consumption tax importantly redefines property rights: it changes what it means for wealth to be one's own.[361] Society has a stake in the private savings accounts, and is justified in regulating them, just as it does now with IRAs and pension plans. Simply forbidding monies in tax-favored accounts from being used to finance personal political pursuits, for example, would go a long way — farther than the current tax system and farther than the current regulation of campaign financing — toward curtailing the power of private capital to influence politics.

In short, the problems of private capital as private power, far from posing objections to a consistent, progressive postpaid consumption tax, seem to offer a powerful set of reasons for such a tax.

5. *Transitions*

Finally, it is often thought or written that transition concerns loom large in adopting any form of a consistent consumption tax. While any large-scale tax reform does indeed pose difficult problems of implementation and transition, the new understanding of tax helps to show that there are ways in which this usual and customary objection is overstated, or at least misstated. Practically, all that need be done is to repeal the limits on traditional IRAs and include debt as income. Taxing debt poses challenges, to be sure, but the rest does not; the move to a consistent postpaid consumption tax is mainly a simplifying one. Still, scholars fret that moving from a system that directly taxes capital — in theory — to one that does not will create problems. The concern is usually put in the terms of the traditional view of tax, that is, as if we were moving from an income ideal to a consumption one. In such a case, it appears as if "old" capital would suffer a fatal blow, whereas "new" capital would be blessed.[362]

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361. *See* McCaffery, *The Right to Waste?*, *supra* note 24.

362. This leads to the problem of preenactment basis, a concern which I feel is overstated. *See* Kaplow, *supra* note 355.

But in fact, as the new understanding of tax shows, we do not have an income ideal. A good deal of capital has not yet been taxed under the existing hybrid. Further, as noted above and below, it is wrong to simply assume that any conversion to a consistent consumption tax would mean an increase in rates. A move to a consistent postpaid consumption tax would entail two major base-broadening features: the elimination of preferential rates for capital gains and other sources of capital income, such as dividends, and the inclusion of debt-financed consumption. These would be balanced against the more systematic deduction for savings, bearing in mind that much savings already escape tax.

On another hand, the new understanding of tax points to a new set of transition issues. Whereas moving from an income tax ideal to a prepaid consumption model is simple enough — one gets there by repealing all second taxes on capital, as current policy seems bent on doing — and the transition from an income ideal to a postpaid consumption one has at least been well-studied, the new understanding argues for the replacement of a prepaid with a postpaid consumption tax model. While actual law has allowed conversions of IRAs in the other direction — from traditional to "Roth" style[363] — the converse can be tricky. The attendant problems warrant study.

C. *Common Errors About Income and Consumption Taxes*

We have come a long way, using many words, covering the intellectual history of tax, the status quo, tax theory and practice in the income and other taxes, and more. Now it is time to be brief, to list some lessons and final thoughts. Before concluding, this section simply lists and comments on some common mistakes in the popular understanding of tax systems based on the traditional understanding of tax that have been impeding better, more fruitful discussion about tax reform. The new understanding of tax helps to set things straight.

1. *We Have an Income Tax*

As the growing cognitive psychological literature shows us abundantly well, labels matter.[364] The major comprehensive tax system in America is officially termed the "income" tax, and virtually all political discourse about it takes it as such. Yet the tax system we have is far closer to a consumption tax because of its many omissions of taxing capital and its yield. More specifically, under the new

363. I.R.C. § 408A(d)(3)(C) (2004).

364. *See* Edward J. McCaffery & Jonathan Baron, *Heuristics and Biases in Thinking about Tax*, *in* Proceedings of the 96th Annual Conference on Taxation, 2002, 443 (2003).

understanding of tax, we are moving ever closer to a prepaid consumption or wage tax. Second taxes have become voluntary.

2. *The Principal Choice in Comprehensive Tax Policy Is Between an Income and a Consumption Tax*

A central goal of the new understanding of tax has been to show that the classic income-versus-consumption debate is moot. We do not have, have never had, and will never have an income tax. The real choice is and ought to be over what form of consumption tax to have. Here the stakes are large and dramatic.

3. *Consumption Taxes Are Flat Taxes*

This is a confusion present in certain popular political discourses, one that conservative politicians have used to their advantage. Further, it relates back to Mill and an important theme in the tax policy literature. If the reason for supporting a consumption tax is to preserve the pretax equality between savers and spenders — to effect yield exemption — then there is indeed something compelling about a flat-rate structure. That is why a large element of the new understanding of tax lies in establishing the idea that this horizontal equity argument is not the right reason for a consumption tax.

4. *All Consumption Taxes Are Created Equal*

All flat consumption taxes are indeed largely equal, except for the important points about infra-marginal returns to capital. But progressive consumption taxes vary greatly. A prepaid consumption or wage tax, even at progressive rates, features yield-exemption, by design; a postpaid consumption tax most decisively does not.

5. *Consumption Taxes Do Not Reach the Yield to Capital*

The dominant analytic point of the new understanding of tax is that, under progressive rates, a postpaid consumption tax reaches the yield to capital when such yield is the source of enhanced lifestyles, but not otherwise.

6. *The Best Argument for a Consumption Tax Is One of Horizontal Equity*

Here is where we can blame Mill, again, and take objection to Andrews's "most sophisticated" argument. Indeed and ironically, a very good reason for consumption taxes, of the right sort, is that they fall on the yield to capital under just the circumstances in which

ordinary moral intuitions suggest that this is the right thing to do. But there are other good reasons for a consumption tax, of the right sort, most importantly including that a consistent postpaid consumption tax opens the door to deeper, more-lasting progressivity in the allocation of tax burdens.

7. *The Case for Consumption Taxation Is One About the Importance of Capital, on the Individual or Aggregate Level*

Here is where we perhaps can blame Hobbes, and his "foundational" argument for consumption taxation based on the common pool of capital.[365] Depending on the rate structure, there can be more, less, or the same amount of capital under a consumption as under an income tax. Indeed, in part because a consistent postpaid consumption tax facilitates more progressivity — a steeper slope in the rate structure — than we now have, it is possible that tax rates could decrease on the lower income classes while increasing on the upper ones. In such a case we might get less savings among the poor and more savings among the rich, which can be a compelling normative endpoint, especially given a basically just society that provides basic needs and goods to all its citizens.[366]

8. *Rates Would Have to Increase Under a Transition to a Consumption Tax*

The standard income-versus-consumption debate assumes that rates would have to increase under any conversion to a consumption tax, at constant revenue needs, because the consumption tax fails to reach an element of the income tax's base, namely savings. In fact, we do not have an income tax. In moving from the status quo — the flawed income-with-realization tax — to a consistent, postpaid consumption tax, there would be two large base broadening features. First, we could repeal the special rate preferences for capital gains and corporate dividends.[367] Second, we would have a mechanism for picking up debt, and thus would add debt-financed consumption to the base. These two provisions could well offset the greater allowance of deductions for savings, especially as so little savings is taxed today.

365. Hobbes, *supra* note 57; Fried, *supra* note 7, at 962 (calling Hobbes's argument foundational).

366. *See* RAWLS, *supra* note 52, at 90-95, 277.

367. Because a consistent postpaid consumption tax eliminates the need for the concept of "basis," the base would also broaden by including gain now lost to the over-stated basis problem. *See* Dodge & Soled, *supra* note 220.

9. *The Gift and Estate and Corporate Income Taxes Are Important Backstops to the Individual Income Tax*

The traditional view of tax sets an income tax against all forms of consumption taxes. Most tax policy scholars and makers through the years have favored the former, for they ascribe to the yield-to-capital norm. But the status quo individual income tax disappoints, for it fails to get at the yield to capital in many, and many of the most important, cases. Thus, the gift and estate and corporate income taxes are desired as "backstops" to the income tax, as some way of getting at the yield to capital. But in practice these taxes are porous in their application, and unfair in their incidence. Under the new understanding of tax, we can see that a consistent, progressive postpaid consumption tax does get at the yield to capital, in the right cases, in a principled and individuated manner. Thus, under it, and putting aside the analytically separable question of the problems of capital-as-power, these two additional taxes are not needed.

10. *Adopting a Consumption Tax Would Be a Radical Change*

If one believes that the great fault line in tax policy is between an income and a consumption tax, and that we have the former, then a change to a consumption tax seems radical. But it is not. We do not have an income tax, and the only real question is what kind of consumption tax to have. Adopting a consistent, postpaid consumption tax would entail only two major steps: (1) institute an unlimited deduction for savings, along the lines of traditional IRA plans; and (2) include debt as a taxable input. At the same time, we could repeal: (1) all preferences for capital gains, corporate dividends, and the like; (2) all rules relating to "basis" (as assets would have no basis, not having been taxed); (3) the corporate income tax; and (4) the gift and estate tax. While there are important transitional concerns, such as those over "pre-enactment basis," these tend to be overstated.

D. *Tax Matters*

Why does the new understanding of tax matter? Because tax matters. Tax represents the last battle line for any meaningful redistribution of material resources from the better able to the least well off.[368] The traditional view of tax gives us an impoverished choice

368. Or perhaps it does. There is also some hope for effecting redistribution through expenditure programs. *See* Bird & Zolt, *supra* 51; *see also* Baron & McCaffery, *Masking Redistribution*, *supra* note 21 (experimental results showing that ordinary subjects fail to compensate in tax system for decline in redistribution attendant on "privatization" of formerly publicly provided goods and sources).

set, between a wildly unpopular income-plus-estate-plus-corporate-income tax regime that is scarcely doing any real work in the cause of liberal egalitarian justice, and a flat consumption tax of some sort or another that cannot *possibly* do any such work. The new understanding of tax is essential to getting us out of this morass.

The traditional view of tax pits income against consumption taxes, with income taxes, alone, on the side of liberal egalitarian justice and fairness in tax. Under its dim lights, liberals continue to cling to and argue for a porous income plus corporate income plus gift and estate tax regime, all unpopular and ineffective choices. Meanwhile, conservative forces opposed to redistribution have begun to see the light of the new understanding. They are arguing, not just for a consumption tax, but for a *particular form* of consumption tax: a prepaid one. To them, victory seems close at hand. With President Bush's reelection, prepaid consumption proponents have been speaking openly of their mounting piecemeal victories and the ever-closer horizon of their promised land. The highly influential Grover Norquist, for example, notes of the four tax cuts in Bush's first term that "[p]eople looked at those and thought they were just catch as catch can. But every one of those tax cuts moved us toward a single-rate tax system that taxes income just one time."[369] Stephen Moore, president of the powerful Club for Growth, foresees not "a big grandiose plan, but rather incremental steps." Moore regards the flat tax as the "Garden of Eden . . . [that requires] that every change we make with tax policy is moving us in that direction."[370] The new understanding of tax would have helped to predict the ultimate effects of this gradual shift.[371] Now that we stand on the brink of getting a flat wage tax, ordinary people are beginning to size up, comprehensively, where we are.[372]

What they see is not bright. These are dark times for the great progressive spirit in America. We have, perhaps wisely, rooted out many vestiges of inefficient and haphazard redistribution from our general socio-economic laws and regulations, persuaded in part by a welfarist economic argument that such redistribution is best left to the

369. Warren Vieth, *U.S. Tax Code May Be Facing a Full Rewrite*, L.A. TIMES, Nov. 7, 2004, at A27. I have been making this point for a while.

370. *Id*.

371. *See* Edward J. McCaffery, *Ten Facts About Fundamental Tax Reform*, 101 TAX NOTES 1463 (2003).

372. *See*, *e.g.*, *Primer: Consumption Tax*, WASH. POST, Nov. 7, 2004, at F3 (the Washington Post's basic explanation of the consumption tax). Tax scholars too are concerned. *See, e.g.*, Martin M. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 998-1012 (2004) (presenting data showing that the extremely rich are getting richer); William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration*, 45 B.C. L. REV. 1157, 1220-31 (2004).

tax system.[373] But when we look at that tax system, whose very design once served as a shining light of progressive liberalism, we see a steady retreat towards something very different from where we started. More darkly still, we seem ill-served by our intellectual armament to halt the retreat. Most people pay little or no attention to the frightening details of tax, deterred and dismayed by its dizzying complexity. Those who do know, and care, are trapped in the traditional income-versus-consumption debate. Progressives fight to maintain whatever vestiges of an income tax we have, and defend its adjutants, the corporate and gift and estate taxes, as the last best hope for justice in tax and, by extension, in society at large. Yet these very choices are giving comfort to the enemies of redistribution, for the income, corporate, and gift and estate taxes are wildly unpopular — and, ironically, wildly ineffective to boot. The tax system is drifting, seemingly inexorably, towards a flat wage tax. All hope for effecting redistribution from rich to poor may soon be lost. Amidst the darkness, dramatic change seems beyond the pale; the very tinkering that has gotten us into the state of tax we are in seems to be the only procedure for going forward. "People treat a plan as realistic when it approximates what already exists and as utopian when it departs from current arrangements. Only proposals that are hardly worth fighting for — reformist tinkering — seem practicable."[374]

But perhaps it is darkest before the dawn. By rethinking first principles in the analytics of tax, we can come to a new understanding. An income tax is not needed to advance the progressive cause, and in fact its very structure impedes it. Yet all consumption taxes are not created equal. While a prepaid consumption or wage tax does indeed let capital off the social hook altogether, a consistently progressive, postpaid consumption tax gets matters just right, by design. It comports with compelling ordinary moral intuitions about the taxation of capital and its yield, allowing people to lower the burden of taxation by ordinary-savings, but falling on the yield to capital when it facilitates a better, richer lifestyle. Such a tax, alone among feasible alternatives, allows for a structure in which a deep and meaningful progressivity in the allocation of tax burdens can flourish. It is not where we are headed now, but it could yet be where we end up — if we get our understanding of tax down right.

373. *See* KAPLOW & SHAVELL, *supra* note 21.

374. ROBERTO MANGABEIRA UNGER, FALSE NECESSITY 12 (1987).